



# PEOPLE'S REPUBLIC OF CHINA— HONG KONG SPECIAL ADMINISTRATIVE REGION

## FINANCIAL SECTOR ASSESSMENT PROGRAM

July 2014

### BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION—DETAILED ASSESSMENT OF OBSERVANCE

This Basel Core Principles for Effective Banking Supervision Detailed Assessment Report was prepared in the context of the Financial Sector Assessment Program for the People's Republic of China—Hong Kong Special Administrative Region.

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FINANCIAL SECTOR ASSESSMENT PROGRAM

June 2014

## DETAILED ASSESSMENT OF OBSERVANCE

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING  
SUPERVISION DETAILED ASSESSMENT OF  
COMPLIANCE

Prepared By  
**Monetary and Capital Markets  
Department**

This Detailed Assessment Report was prepared in the context of Financial Sector Assessment Program (FSAP) missions in People's Republic of China—Hong Kong Special Administrative Region (HKSAR) during August and November 2013 led by Carlos Medeiros, and overseen by the Monetary and Capital Markets Department.

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## Glossary

AI	Authorized (deposit-taking) institution
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
AMLO	Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance
BCP	Basel Core Principles for effective banking supervision
BCBS	Basel Committee on Banking Supervision
BO	Banking Ordinance
BSRC	Banking Supervision Review Committee
CAR	Capital Adequacy Ratio
CCASS	Central Clearing and Settlement System
CCE	Commissioner of Customs and Excise
CCRA	Commercial Credit Reference Agency
CFR	Council of Financial Regulators
CHATS	Clearing House Automated Transfer System
CMG	Crisis Management Group
CO	Companies Ordinance
CP	Core Principle
DPB	Deposit Protection Board
DPS	Deposit Protection Scheme
DPSF	Deposit Protection Scheme Fund
DPSO	Deposit Protection Scheme Ordinance
DTC	deposit-taking companies
DvP	delivery-versus-payment
EFO	Exchange Fund Ordinance
ELA	Emergency Liquidity Assistance
FRC	Financial Reporting Council
FS	Financial Secretary
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSBCC	Financial Services Branch Coordination Centre
FSC	Financial Stability Committee
FSTB	Financial Services and the Treasury Bureau
G-SIB	Global Systemically Important Bank
G-SIFI	Global Systemically Important Financial Institution
HSBC	Hongkong and Shanghai Banking Corporation Limited
HKCIB	Hong Kong Confederation of Insurance Brokers
HKEx	Hong Kong Exchanges and Clearing Limited
HKFE	Hong Kong Futures Exchange Limited
HKFRS	Hong Kong Financial Reporting Standards
HKMA	Hong Kong Monetary Authority
HKICPA	Hong Kong Institute of Certified Public Accountants

HKSA	Hong Kong Standards on Auditing
HKSCC	Hong Kong Securities Clearing Company
IA	Insurance Authority
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
ISA	International Standards on Auditing
ICO	Insurance Companies Ordinance
LOLR	Lender of Last Resort
MA	Monetary Authority
MLO	Money Lenders Ordinance
MOU	Memorandum of Understanding
MPF	Mandatory Provident Fund
MPFA	Mandatory Provident Fund Schemes Authority
MPFSO	Mandatory Provident Fund Schemes Ordinance
MSC	Macprudential Surveillance Committee
ORM	Operational Risk Management
ORSO	Occupational Retirement Schemes Ordinance
PIBA	Professional Insurance Brokers Association
PRC	People's Republic of China
PvP	payment-versus-payment
RLB	Restricted license banks
RRP	Recovery and Resolution Planning
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance
SFST	Secretary for Financial Services and the Treasury
SEHK	Stock Exchange of Hong Kong Limited
SPM	Supervisory Policy Manual
SRO	Self-regulatory organizations

# SUMMARY OF KEY FINDINGS AND PRECONDITIONS

## A. Introduction

1. **HKSAR has a very high level of compliance with the Basel Core Principles (BCPs) for Effective Banking Supervision.** The HKMA supervises a major international financial center which was affected, though not significantly so, by the financial crisis. The banking system is characterized by the dominant presence of institutions with foreign ownership, including the systemic note-issuing banks, which puts a premium on the Hong Kong Monetary Authority's (HKMA's) role as a host supervisory authority.
2. **The HKMA is maintaining its commitment to the international regulatory reform agenda and is an early adopter of many standards.** Supervisory practices, standards and approaches are well integrated, risk based and of very high quality. A number of the HKMA practices around corporate governance issues, including close and continuing attention to fit and proper standards and to the role played by the Board of an authorized institution (AI) deserve particular commendation.
3. **There is one area in relation to the overarching legislative framework and powers which warrants further attention.** The HKMA enjoys clear de facto but not de jure operational independence. Taken as a whole, there is much very good practice and certain important safeguards are in place, such as the potential for judicial review of decisions taken by government authorities. Nonetheless, the independence of the HKMA is not as fully protected by law as it could be.
4. **There are two important cross border dimensions for Hong Kong as an international financial center.** One is related to HKSAR's significant position as a host supervisor. The second is the increasing importance of Mainland China in the current portfolios and future prospects of the locally incorporated institutions, and indeed in the choice of HKSAR as a platform for overseas institutions to establish relationships with Mainland China. The HKMA is alert to the potential risks of these dimensions and reflects this awareness in its supervisory planning, activities and relationships with other authorities. Nonetheless, techniques of cross border oversight continue to evolve and the HKMA is urged to remain in the forefront of, and contribute to, developing international supervisory practice, as it already recognizes it needs to do.
5. **There are minor regulatory gaps both in respect of the HKMA's powers and regulatory definitions.** At present the good practices surrounding lending to parties related to the AI do not apply to its management. Consequently, the definition of related party (or the equivalent term in the Banking Ordinance, BO) needs to be expanded. In relation to external auditors, the HKMA does not have the explicit power to remove the auditor of an AI or to have direct access to the external auditor's working papers. While the HKMA has been able to work around these restrictions, amendments to the appropriate legislation should be made.

## B. Information and Methodology Used for Assessment

**6. This assessment of the BCP for Effective Supervision is part of the 2013 FSAP update for HKSAR.** The assessment of the HKMA was conducted during an IMF mission that visited HKSAR from November 7–26, 2013.<sup>1</sup> HKSAR is among the early jurisdictions to be assessed against the BCP methodology issued by the Basel Committee on Banking Supervision (BCBS) in September 2012. In their self-assessment the authorities addressed both essential and additional criteria and the assessors have based their conclusions on compliance with both criteria. The last BCP assessment was conducted in 2002.

**7. It should be noted that the ratings assigned during this assessment are not directly comparable to previous assessments.** Gradings cannot be compared between this assessment and the former assessment as each has taken place under a different iteration of the methodology. In fact the methodology had been revised twice, in 2006 and again in 2012, since the last assessment and HKSAR was not assessed against the 2006 methodology. In revising the Core Principles (CPs) to reflect the lessons from the recent financial sector crisis, the BCBS has sought to raise the bar for sound supervision and to update the principles on the basis of emerging supervisory best practices. New principles have been added to the methodology along with new essential criteria for each principle that provide more detail and additional criteria that raise the bar even higher. Altogether, the revised CPs now contain 247 separate essential and additional criteria against which a supervisory agency may now be assessed. In particular, the revised BCPs strengthen the requirements for supervisors, the approaches to supervision and supervisors' expectations of banks. While the BCP set out the powers that supervisors should have to address safety and soundness concerns, there is a heightened focus on the actual use of the powers, in a forward-looking approach through early intervention.

**8. The assessment team reviewed the framework of laws, rules, and guidance and held extensive meetings with officials of the HKMA, and additional meetings with the Financial Services and the Treasury Bureau (FSTB), auditing firms, professional bodies, and banking sector participants.** The authorities provided a comprehensive self-assessment of the CPs, as well as detailed responses to additional questionnaires, and facilitated access to supervisory documents and files on a confidential basis as well as staff and systems.

**9. The team appreciated the very high quality of cooperation received from the authorities.** The team extends its thanks to staff of the authorities, who provided excellent cooperation, including extensive provision of documentation and technical support, at a time when many other initiatives related to domestic and global regulatory initiatives were in progress.

**10. The standards were evaluated in the context of the Hong Kong financial system's sophistication and complexity.** The CPs must be capable of application to a wide range of jurisdictions whose banking sectors will inevitably include a broad spectrum of banks. To

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<sup>1</sup> The assessment team comprised Katharine Seal (IMF) and Elizabeth Roberts (ex Financial Stability Institute, Consultant).

accommodate this breadth of application, a proportionate approach is adopted within the CP, both in terms of the expectations on supervisors for the discharge of their own functions and in terms of the standards that supervisors impose on banks. An assessment of a country against the CPs must, therefore, recognize that its supervisory practices should be commensurate with the complexity, interconnectedness, size, and risk profile and cross-border operation of the banks being supervised. In other words, the assessment must consider the context in which the supervisory practices are applied. The concept of proportionality underpins all assessment criteria. For these reasons, an assessment of one jurisdiction will not be directly comparable to that of another.

**11. An assessment of compliance with the BCPs is not, and is not intended to be, an exact science.** Reaching conclusions required judgments by the assessment team. Banking systems differ from one country to another, as do their domestic circumstances. Furthermore, banking activities are undergoing rapid change after the crisis, prompting the evolution of thinking on, and practices for, supervision. Nevertheless, by adhering to a common, agreed methodology, the assessment should provide the Hong Kong authorities with an internationally consistent measure of the quality of their banking supervision in relation to the revised CPs, which are internationally acknowledged as minimum standards.

### C. Overview of Institutional Setting and Market Structure

**12. HKSAR has a large and well developed financial system.** The banking sector includes 201 institutions—156 licensed banks, 21 restricted license banks, and 24 deposit taking companies—with assets equivalent to over 735 percent of GDP. The assets of the four largest banks—The Hong Kong 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—account for almost half of the total consolidated assets of the banking system. Lending to the corporate sector represents around half of the banking system's total lending, while property-related lending accounts for about 30 percent.

**13. HKSAR is an open banking market with significant foreign participation.** Of the 156 licensed banks, 135 are foreign branches and 14 are foreign subsidiaries. There is a strong presence from global systemically important banks (G-SIBs) as 27 out of the 29 G-SIBs identified by the Financial Stability Board (FSB) in November 2013 undertake banking activities in HKSAR. Accounting for about 35 percent of total assets of the banking system, foreign branches operate a diversity of business models in HKSAR: some act as group liquidity hubs, some conduct investment banking activities, others are active in corporate lending or the local interbank market, and a few of them also have a substantial retail engagement.

**14. In HKSAR, there are three tiers of deposit-taking institution.** These institutions, collectively referred to as AIs, are regulated and supervised by the Monetary Authority (MA), through his office of the HKMA. These are (i) licensed banks—which can carry on the full range of banking business; (ii) restricted license banks (RLBs) (mostly merchant or investment banks) which may take deposits of at least HK\$500,000 (or an equivalent amount in any other currency) without limit on term; and (iii) deposit-taking companies (DTCs) (principally consumer and trade finance companies)



which may take deposits of at least HK\$100,000 (or an equivalent amount in any other currency) of a tenor of not less than three months.

**15. Hong Kong banks are well capitalized, profitable and have extremely low levels of nonperforming loans.** The banking sector also appears well placed to meet new Basel liquidity standards. Banks' capital adequacy remains robust at around 16 percent, with banks' Tier 1 capital ratio at over 13 percent. Solvency stress tests conducted by the HKMA suggest that banks' capital adequacy is generally resilient to both domestic and external shocks, including sharp increases in interest rates. Profitability is supported by steady improvements in net interest income since the cyclical trough in the first half of 2010. Banks' funding continues to be dominated by customer deposits, with their share of funding constituting around 55 percent of liabilities. Sector wide liquidity, measured at 39 percent according to the HKMA metric is well above the statutory minimum of 25 percent and major banks will be required to adjust to the Basel 3 liquidity coverage ratio that will be implemented in HKSAR from 2015, while other AIs will be required to observe a modified version of the existing liquidity ratio. The loan to deposit ratio has increased steadily since 2009, reaching 72 percent in June 2013.

**16. The Hong Kong securities markets are among the largest in the world and the insurance sector is large and well capitalized.** As of June 2013, the total market capitalization of the stock exchange was US\$2.7 trillion (HK\$20.6 trillion), the sixth largest market capitalization among stock markets worldwide, or 1,000 percent of GDP. Nearly half of the 1,567 listed companies are from Mainland China, representing 56 percent of the total capitalization. In the insurance sector insurance penetration was 12.5 percent of GDP in 2012, predominantly from long-term insurance business. The insurance sector included 155 licensed insurers as at end of 2012—and as in the banking sector, many are foreign owned.

**17. The stability of the system is underpinned by the Exchange Fund.** The Fund includes assets backing the monetary base (HK\$1.3 trillion as of June 2013), the fiscal and other government reserves (HK\$0.9 trillion), plus other assets. Whilst the primary objective of the Fund is to sustain the currency stability (through the Linked Exchange Rate System), it can also be used to maintain the stability and integrity of HKSAR's monetary and financial systems. In particular, it can be used to provide both liquidity and capital to the banking system in circumstances where there are implications for systemic stability and provides the backstop for the Deposit Protection Scheme (DPS). A swap facility with the People's Bank of China provides a renminbi liquidity backstop (of HK\$0.5 trillion).

## D. Preconditions for Effective Banking Supervision

### Sound and sustainable macroeconomic and financial sector policies

**18. HKSAR has a well-established framework of fiscal, monetary and other macroeconomic policies.** HKSAR has a highly externally-oriented economy, resulting in a high correlation to changes in global economic conditions, particularly those affecting the regional markets and its major trading counterparts in the Asian region and the United States. The nature of its economy underlies the importance of the stability of the external value of its domestic currency. In this connection, the

primary monetary policy objective of HKSAR is to maintain currency stability, in terms of a stable exchange rate of the Hong Kong dollar against the U.S. dollar at a linked exchange rate. The linked exchange rate system was established in 1983 and is backed by foreign exchange reserves (of US\$303.5 billion as at end-September 2013).

## **The Framework for Financial Stability Policy Formulation**

### ***Institutional and Legal Setting***

**19. In HKSAR, responsibilities for supervision of financial institutions and markets are divided among four principal financial regulators.** The banking, securities and insurance industries and the operation of the Mandatory Provident Fund (MPF) and occupational retirement schemes are primarily regulated by four financial regulators, namely, the MA, the Securities and Futures Commission (SFC), the Insurance Authority (IA) and the Mandatory Provident Fund Schemes Authority (MPFA). Each of the financial services sectors is subject to a licensing/registration regime and a regulatory framework for ensuring the on-going safety and soundness of regulated entities and the conduct of their business in a proper, prudent manner. The supervisory authorities and agencies seek to ensure effective supervisory cooperation to ensure cross-sector issues of mutual concern can be dealt with in an effective manner.

### ***Monetary Authority***

**20. The principal function of the MA, under the BO, is to promote the general stability and effective working of the banking system.** The objectives of the BO are to regulate banking business and the business of taking deposits; to make provision for the supervision of AIs so as to provide a measure of protection to depositors; to promote the general stability and effective working of the banking system; to make provision for the supervision of money brokers and to provide for matters incidental thereto or connected therewith. The MA has issued ancillary rules and guidelines under the BO in relation to a range of areas and activities. 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. The activity which attracts regulation and supervision by the MA as an AI is the carrying on in Hong Kong of a business of taking deposits. Some nonbanking activities (e.g., securities, insurance and MPF intermediary activities) are conducted by AIs. As their front-line supervisor, the MA is responsible for supervising these activities in collaboration with the SFC, the IA, and the MPFA. AIs are also required to comply with the relevant codes or standards issued from time to time by these authorities.

**21. The MA is also responsible for supervising money brokers which provide interbank broking services for their customers in making deposits of any currency, foreign exchange and related derivative products in HKSAR.** Generally, money brokers do not take, buy or sell positions on their own behalf and only act as intermediaries between principals. In HKSAR, the number of money brokers is small and they do not pose significant systemic risk to the interbank foreign exchange and deposit markets.

***Securities and Futures Commission***

**22. The regulatory objectives of the SFC as set out in the Securities and Futures Ordinance (SFO) include to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry; to provide protection for members of the public investing in or holding financial products; to minimize crime and misconduct in the securities and futures industry; and to reduce systemic risks in the securities and futures industry.** There are 10 “regulated activities” (including dealing in securities, advising on securities, dealing in futures contracts, advising on futures contracts, and asset management) stipulated under the SFO. In addition, the SFC has issued ancillary rules, codes and guidelines to govern specific operations.

***Insurance Authority***

**23. The IA is responsible for regulating and supervising the insurance industry of Hong Kong.** The IA is supported by the Office of the Commissioner of Insurance, a government department in HKSAR. As mandated in the Insurance Companies Ordinance (ICO), the principal function of the IA is to regulate and supervise the insurance industry for the promotion of the general stability of the insurance industry and for the protection of existing and potential policy holders. The IA’s major duties and powers include authorization of insurers, regulation of insurers and insurance intermediaries and liaison with the insurance industry. Insurance intermediaries in HKSAR are subject to a self-regulatory regime, under which self-regulatory organizations (SROs) approved by the IA perform supervisory, investigative, disciplinary and other regulatory functions on insurance intermediaries. Insurance intermediaries are required to be registered with one of the three SROs.

***Mandatory Provident Fund Schemes Authority***

**24. The MPFA’s primary objectives under the Mandatory Provident Fund Schemes Ordinance (MPFSO) are to ensure compliance with the Ordinance and protect the interests of MPF scheme members.** MPF intermediaries (selling and advising on MPF products) are required to be registered by the MPFA under the MPFSO. The MPFA also acts as the Registrar of Occupational Retirement Schemes under the Occupational Retirement Schemes Ordinance (ORSO). ORSO schemes are retirement schemes set up voluntarily by employers.

***Money Service Operators***

**25. The Commissioner of Customs and Excise (CCE) is the authority in charge of licensing and supervising the Money Service Operator sector.** Authorization by the CCE is required under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (AMLO), for any person who wishes to operate money changing and/or remittance services as a business in HKSAR.

***Role of self-regulatory organizations***

**26. In HKSAR there is currently a self-regulatory regime for insurance intermediaries.** Three SROs, namely the Insurance Agents Registration Board under the Hong Kong Federation of Insurers,

the Hong Kong Confederation of Insurance Brokers (HKCIB) and the Professional Insurance Brokers Association (PIBA), are responsible for the registration and conduct regulation of insurance intermediaries. The IA maintains general oversight over the SROs to ensure that they discharge their duties effectively. The self-regulatory framework is set out in Part X of the ICO, which stipulates the registration or authorization requirements for insurance intermediaries and empowers the IA to oversee the SROs. An insurance agent must be appointed by an insurer and the relevant appointment must be duly registered with the Insurance Agents Registration Board in accordance with the Code of Practice for the Administration of Insurance Agents issued by the HKFI. The Code of Practice sets out, among other things, the registration and conduct requirements for insurance agents. Insurance brokers are required to be either authorized directly by the IA or registered as a member of a body of insurance brokers approved by the IA, i.e., the HKCIB and PIBA. Insurance brokers are required to fulfill the minimum requirements stipulated in the ICO, which are elaborated upon in the guideline “Minimum Requirements for Insurance Brokers” issued by the IA.

**27. The Government is proposing to establish an independent IA (IIA).** This move is intended to respond to the rapid development in the insurance market and align with international practices. The self-regulatory regime for insurance intermediaries will be replaced by a direct regulatory regime, under which the IIA will be responsible for the licensing and conduct regulation of insurance intermediaries.

### ***Money Lenders***

**28. Money lenders do not accept public deposits, are mainly funded by equity and must obtain a license under the Money Lenders Ordinance (MLO).** Apart from licensing, the MLO regulates various aspects of money-lending transactions, including the form of loan agreement, advertisements, maximum interest rate, etc. The Licensing Court is responsible for the determination of applications for and granting of money lender licenses; the Registrar of Money Lenders is responsible for processing applications for money lender licenses, renewal of licenses and endorsement on licenses, as well as maintaining a register of money lenders for public inspection; the Commissioner of Police is responsible for enforcing the MLO, including carrying out examinations on applications for money lender licenses, renewal of licenses and endorsement on licenses, and investigations of complaints against money lenders.

**29. The scale of operations of Money Lenders is modest.** Bank borrowings constitute a relatively minor funding source for money lenders, estimated to account for less than 1 percent of banks' total domestic loans. Lending by money lenders is estimated to account for less than one percent of the total loans of the banking sector in HKSAR.

### ***Financial stability coordination***

**30. The HKMA has established the Macro-Surveillance Committee to focus on financial stability and macro prudential analysis.** The Committee is chaired by the MA and its members include Deputy Chief Executives and Executive Directors drawn from both the banking and monetary sides of the HKMA's operations. The committee identifies potential risks and threats to the monetary and financial system in HKSAR and discusses possible measures to address such risks, and reviews existing measures for managing risks in the monetary and financial system to identify possible gaps

and ensure the adequacy of these measures. As part of its macro-financial surveillance, the HKMA publishes a Half-Yearly Monetary and Financial Stability Report. The other major financial sector regulators also have statutory financial stability mandates.

**31. Interagency coordination on financial stability is supported by the Financial Stability Committee (FSC).** The MA, the IA, the SFC and the FSTB of the government meet frequently to discuss regulatory issues, monitor cross-market risks and review issues that may have implications for financial stability. For the financial sector as a whole, an FSC was set up in 2000 to monitor the functioning of the financial system in HKSAR, including the banking, debt, equity, derivatives, insurance and related markets; and deliberate on issues with possible cross market and systemic implications. It reports to the Financial Secretary (FS) regularly and at any time where necessary. The committee, which meets on a monthly basis, is chaired by the Secretary for Financial Services and the Treasury (SFST) of the HKSAR Government and comprises the MA, the Chief Executive Officer of the SFC, and the IA.

**32. The Council of Financial Regulators (CFR) has been established to minimize gaps or duplication in the regulation and supervision of financial institutions.** The CFR facilitates sharing of information and views as well as identification of important trends. It also serves as a platform to review regulatory and supervisory issues with cross-sectoral implications. The CFR is chaired by the FS and consists of the SFST, the MA, the Chief Executive Officer of the SFC, the IA and the Managing Director of the MPFA. The CFR meets on a quarterly basis.

**33. The FSC monitors the functioning of the financial system and deliberates on issues with possible cross sectoral and systemic implications.** The FSC is chaired by the SFST and comprises the MA, the Chief Executive Officer of the SFC, and the IA. The FSC meets on a monthly basis and provides regular reports to the FS. Where regulatory action is needed, the FSC refers matters to the CFR.

## **A Well-Developed Public Infrastructure**

### ***System of business laws***

**34. HKSAR is a common law jurisdiction.** When Hong Kong became a Special Administrative Region of the People's Republic of China (PRC) in 1997, the Basic Law, which sets out the constitutional framework of the Special Administrative Region, came into effect. The Basic Law, enshrines the principle of "one country, two systems" and provides that all the laws previously in force (that is, the common law, rules of equity, ordinances, subordinate legislation and customary law) in HKSAR shall be maintained, except for any that contravene the Basic Law and subject to any amendment by the legislature of the HKSAR. Presently, laws in HKSAR consist of the Basic Law, locally enacted Ordinances, subsidiary legislation, the common law, rules of equity and customary law.

**35. Orderly dispute resolution is governed by relevant ordinances.** The Companies Ordinance (CO), Bankruptcy Ordinance, and the High Court Ordinance address orderly resolution of contractual disputes and enforcement of legal remedies. An effective court system (see below)

further safeguards the enforceability of the respective rights of contractual parties. Alternative mechanisms for resolving disputes outside of court include arbitration and mediation.

### ***Efficient and independent judiciary***

**36. The legal profession in HKSAR is divided into two distinct branches— barristers and solicitors.** Generally, solicitors have limited rights of audience before the courts whereas barristers have unlimited rights of audience in all courts. The professional ethics and conduct of barristers and solicitors are monitored by their respective self-governing bodies, namely the Hong Kong Bar Association and the Law Society which are responsible for professional conduct and ethical standards.

**37. The courts of justice in HKSAR comprise the Court of Final Appeal (which is the highest appellate court in the region), the High Court (which comprises the Court of Appeal and the Court of First Instance), the District Court, the Magistrates' Courts, the Coroner's Court, and the Juvenile Court.** Each court has its own jurisdiction. In addition, there are a number of tribunals which adjudicate on disputes relating to specific and defined areas. They include the Lands Tribunal, Labor Tribunal, Small Claims Tribunal, and Obscene Articles Tribunal.

**38. The HKSAR courts are operated by a Judiciary independent of the executive organ of the government and the legislature.** Judicial appointment under the Basic Law is by the Chief Executive of the HKSAR on the recommendation of the Judicial Officers Recommendation Commission, an independent statutory body composed of local judges, and professionals. Judges have security of tenure until they reach retirement age and may only be removed for inability to discharge duties or misbehavior, by the Chief Executive on the recommendation of a tribunal appointed by the Chief Justice of the Court of Final Appeal. Judgments and awards of the Hong Kong High Court and above may be enforced on a reciprocal basis in a number of foreign jurisdictions including Australia, Belgium, France, Germany, India, Israel, Italy, New Zealand, and Singapore.

### ***Accounting principles and rules***

**39. The CO imposes the obligation to keep proper accounts on companies in HKSAR.** The accounts are prepared based on the Hong Kong Financial Reporting Standards (HKFRS) issued by the Hong Kong Institute of Certified Public Accountants (HKICPA). The HKFRS are in line with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

### ***System of independent external audits***

**40. The accounts are audited according to the Hong Kong Standards on Auditing (HKSAs), issued by the HKICPA.** The HKSAs are based on the International Standards on Auditing (ISA) issued by the IASB. Under these standards, the auditors are required to comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements as a whole are free from material misstatement. Audits must be carried out by a practicing Certified Public Accountant. Practicing company auditors are regulated by the HKICPA

under the Professional Accountants Ordinance, which empowers the HKICPA to monitor compliance with professional standards by auditors and to conduct formal investigation or to take disciplinary action. Where the company is a listed entity, investigation into possible auditing and reporting irregularities is conducted by the Financial Reporting Council (FRC), which is a statutory independent body constituted under the FRC Ordinance.

### ***Availability of competent, independent and experienced professionals***

**41. HKSAR is one of the major international financial center in the world and, as a consequence, has attracted a significant population of highly qualified professionals particularly in the field of banking and finance.**

### **Regulation and supervision of other financial markets**

**42. There is a well developed framework for the regulation and supervision of nonbanking financial activities in HKSAR.** The MA is the frontline supervisor for AIs conducting regulated nonbanking financial activities (i.e., securities, insurance and MPF intermediary activities).

### **Payment and clearing systems**

**43. There are four principal payment systems providing large value interbank payments under a real time gross settlement system.** The Hong Kong dollar, U.S. dollar, and renminbi payment systems handle interbank as well as bulk clearing and settlement while the euro payment system processes only interbank payments. The four Clearing House Automated Transfer Systems (CHATS) in HKSAR link with the Central Moneymarkets Unit to provide both real-time and end-of-day delivery-versus-payment (DvP) settlement services, including the interest-free intraday repo transactions. The four CHATS are also inter-linked to establish six cross-currency payment-versus-payment (PvP) links. Apart from the domestic DvP and PvP links, the HKMA has established a number of cross-border links with other central banks in the Asian region.

**44. Clearing systems are well developed and well connected.** The Central Moneymarkets Unit has external links with international debt securities settlement systems such as Euroclear and Clearstream. Transactions on the Stock Exchange of Hong Kong Limited (SEHK) and the Hong Kong Futures Exchange (HKFE) are cleared and settled through their three associated clearing houses, namely, the Hong Kong Securities Clearing Company (HKSCC), SEHK Options Clearing House and HKFE Clearing Corporation. Clearing and settlement of securities transactions in the stock market are carried out by the HKSCC through the Central Clearing and Settlement System (CCASS). There are system links between the CCASS and the three CHATS to support real-time DvP services (i.e. simultaneous settlement of both the securities and the payment legs of a transaction).

### **Credit bureaus**

**45. There are two major private credit bureaus operating in HKSAR.** One focuses on consumer credit data sharing. The other, namely the Commercial Credit Reference Agency (CCRA), focuses on commercial credit data sharing. Sharing consumer credit data through credit reference agencies is governed by the Code of Practice on Consumer Credit Data (Code) issued by the Privacy Commissioner for Personal Data. The CCRA covers small and medium-sized enterprise customers

which are non-listed limited companies with an annual turnover not exceeding HK\$50 million as well as sole proprietorships and partnerships. The HKMA expects all AIs involved in the provision of credit to participate as fully as possible in the sharing and use of such data and has issued guidelines setting out the minimum standards that AIs should observe.

## **Framework for Crisis Management, Recovery and Resolution**

### ***Powers***

**46. Each of the regulators referred to above have powers which can be deployed for the prevention and handling of crisis situations.** The MA uses trigger ratios and stress testing to provide early warning of potential problems and enable timely remedial action to be taken as well as using supervisory intervention powers, such as those under section 52 of the BO where certain conditions are met, to seek to contain and remedy a situation with a view to protecting the interests of depositors. (Please see also CPs 1 and 11).

### ***Emergency Liquidity Assistance***

**47. The Exchange Fund can be used in a crisis affecting the banking system.** The Exchange Fund is a discrete government fund, separate from the general revenue, established, used and controlled in accordance with the Exchange Fund Ordinance (EFO), which may be deployed to provide capital or liquidity support where the failure of an AI is assessed to have systemic consequences. The HKMA has published a policy on its role as lender of last resort (LOLR) for the granting of emergency liquidity assistance (ELA) to banks.<sup>2</sup> The basic precondition is the judgment of the MA that the failure of an AI incorporated in HKSAR, if it is deprived of liquidity assistance, would damage the stability of the exchange rate, monetary or financial systems of HKSAR (i.e., systemic risk). Under this policy framework, ELA can only be granted to a solvent bank and provided, among other preconditions, that there is no prima facie evidence that the management of the bank is not fit and proper or that the distress is a result of fraud.

**48. ELA may be provided for a period of a maximum 30 days, with a possible 30 days extension.** The LOLR policy states that ELA is not intended for purposes other than short-term liquidity support. The HKMA will charge an appropriate interest rate to be decided in each specific case and which is sufficient to maintain incentives for good management. However, the rate will not be set so high that recovery efforts are undermined. The scale of support is related to the capital adequacy of the bank, up to 200 percent of the bank's capital base for banks with a capital adequacy ratio (CAR) in excess of the statutory minimum, subject to an absolute limit of HK\$25bn to a single bank. ELA may be provided in foreign currencies if needed.

**49. In addition to liquidity support, the Exchange Fund may also be used to provide capital support to a problem bank.** The terms and conditions for such support are not formally established or publicly disclosed as is the case for LOLR, but the MA has the power under the EFO to use the

<sup>2</sup> Policy Statement on the Role of the HKMA as Lender of Last Resort" issued by the HKMA (March 2009) available at: <http://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2009/lolr.doc>



Exchange Fund to provide such support as he thinks fit to maintain the stability and the integrity of the monetary and financial systems of HKSAR. The MA would in practice seek the FS's approval of his decision to provide capital support although in law there is no requirement to do so as the power to use the Exchange Fund for this purpose has been unconditionally delegated to the MA and he has complete discretion as to its exercise.

### ***Information exchange and cooperation***

**50. Memoranda of Understanding (MOUs) support bilateral information exchange and coordination between regulatory authorities.** For example, the MA has entered into comprehensive MOUs with his three principal counterparts—the SFC, IA, and MPFA.<sup>3</sup> Under the MOUs, the parties agree to identify dedicated points-of-contact for coordinating interactions; commit to hold regular meetings to discuss matters of mutual interest relating to the performance of their regulatory and supervisory functions; and commit to information-sharing on specified trigger events, such as violations of regulatory requirements. Information sharing between the principal sectoral regulators is based on their respective ordinances (e.g., section 120 and section 121 of the BO, section 378 of the SFO, section 53A of the ICO, and sections 42 and 42AA of the MPFSO).

**51. The FSTB plays a coordinating role in a crisis situation and may activate a Financial Services Branch Coordination Centre (FSBCC).** The FSBCC facilitates communication in circumstances of high market volatility, or if a contingency event occurs in any segment of the financial sector. FSBCC serves to ensure that front-line regulators' actions and media responses are consistent with each other and that the flow of information between regulators is unobstructed. The FSBCC has broad reach since it can facilitate the sharing of pertinent information with segments of the government that under normal circumstances would not be involved in financial sector matters. Also, FSBCC serves as a focal point of communication, information or assistance seeking between regulators and relevant government bureaus and departments, as well as liaison with the press. The FSBCC has been activated on several occasions in recent years.

### ***Recovery and resolution planning***

**52. The HKMA is developing formal requirements for AIs in relation to recovery and resolution plans (RRPs).** In late 2012, the HKMA began a consultation process on the requirements for RRP and expects to issue guidance on recovery planning in early 2014. A Supervisory Policy Manual (SPM) module on recovery planning was issued for industry consultation in November 2013. Implementation of the requirements is expected to occur in phases, prioritizing institutions whose failure could pose the greatest risk to financial stability. It is expected that the first group of AIs will be required to submit recovery plans in the third quarter of 2014 and resolution plans will follow.

**53. The HKMA participates in Crisis Management Groups (CMGs) for the G-SIBs that have significant operations in HKSAR.** At present, the CMGs are focused on group-level RRP. The

<sup>3</sup> Certain of the MOUs entered into by the MA, including those with the SFC, the IA and the MPFA are available at: <http://www.hkma.gov.hk/eng/key-functions/banking-stability/banking-policy-and-supervision/supervisory-co-operation.shtml>

HKMA proposes to set local recovery and resolution requirements, under which the local operations of cross-border groups would need to set out further detail tailored to the local context. Ultimately, it is proposed that these RRP requirements would apply to all AIs, albeit RRP requirements would be proportionate and so less detailed for small and non-complex institutions.

### ***Bank resolution and liquidation***

**54. The MA can draw on his existing intervention powers should there be significant deterioration in the condition of an AI.** In cases where the viability of an AI is under threat, these powers are designed to support supervisory intervention, to secure remedial action by the AI or the taking of protective measures. Ultimately, where viability is fundamentally undermined, the MA is empowered to revoke authorization or to make a report to the Chief Executive in Council which can in turn direct the FS to seek the initiation of liquidation proceedings.

**55. Where an AI is no longer viable, the MA can draw on the powers made available under section 52 of the BO.** The powers provided for under section 52, which are most relevant to a resolution scenario, are those that allow the MA to (i) issue binding directions to an AI to take any action or do anything whatsoever in relation to “its affairs, business and property” and (ii) appoint a Manager to an institution to manage such of the affairs, business and property of the institution as may be directed by the MA in accordance with an objective set by the MA not inconsistent with the provisions of the BO (the Manager could for example sell or dispose of the business or property of the AI).

**56. Nevertheless the MA’s powers in a resolution scenario are subject to certain limitations and do not provide for all the resolution options which the FSB’s Key Attributes say must be available.** The Hong Kong authorities have carried out several self assessments against the requirements of the FSB’s Key Attributes, most recently to support the FSB’s Peer Review the report of which was published in April 2013. These assessments have identified a series of gaps which need to be addressed and the FSTB, in conjunction with the HKMA, SFC, and IA, are drawing up proposals on a common framework for resolution of financial institutions by means of a single resolution regime for HKSAR. It is expected that two rounds of public consultations will take place in 2014 before introducing a Bill into the Legislative Council in 2015.

**57. In general, the winding-up of an AI is governed by the CO under the same rules that apply to any other company albeit subject to certain modifications under the BO.** Accordingly, any creditor may petition the court for a winding up of an AI and the Court may grant the petition under fairly standard grounds (i.e., inability to pay debts). In addition, the FS can petition for the winding-up of an AI under the BO, either at the direction of the Chief Executive in Council (following a report to the Chief Executive in Council from the MA in exercise of the MA’s powers under section 52) or on his own initiative, following an investigation by the FS (conducted at the behest of the MA) into the state and conduct of the affairs, business and property of the AI. Where a petition for winding up of an AI is presented to the Court by a person other than the FS, a copy of the winding-up petition must be served on the MA, and he shall be entitled to be heard on the petition if the FS is not the petitioner. In the few cases where an AI has been liquidated, the MA has refrained from

revoking the authorization of the AI until late in the liquidation process to ensure that the MA retains his statutory powers in relation to the AI.

## **The Adequacy of Systemic Protection (or Public Safety Net)**

### ***The Deposit Protection Scheme***

**58. The DPS and the Deposit Protection Scheme Fund (DPSF) are governed by the Deposit Protection Scheme Ordinance (DPSO).** The Hong Kong Deposit Protection Board (DPB) acts only as a pay-box agency and its statutory functions are confined to the assessment and collection of contributions, managing the DPSF, making compensation payments to depositors and recovering payments from the assets of the failed Scheme member. Currently, the DPSF can only be used for payout, but not for other resolution purposes.

**59. Membership of the DPS is compulsory for all licensed banks unless the deposits are covered by the home country deposit guarantee scheme.** However, the home country scheme must be adequately underpinned and provide protection at least commensurate with Hong Kong standards. At the time of the assessments two German branches were exempted from joining the DPS.

**60. All depositors, including individuals and corporates other than AIs are covered.** All deposits under five years of maturity are covered. Off shore deposits, structured deposits, bearer form deposits (e.g., bearer certificates) and deposits from an excluded person such as a related company of the Scheme member, an AI or a director or controller of the Scheme member or its related company, are not covered by the DPS.

**61. When the scheme is activated, deposits may be compensated by up to HK\$500,000 (US\$64,000) per depositor and bank.** Compensation is on a net basis, i.e., after deducting liabilities from the deposits of the customer with that bank. Depositors receive priority over other general unsecured creditors. At the time of the assessment, 91 percent of depositors were fully covered.

**62. The DPS is funded by annual contributions collected from member banks on a differential premium basis,** Details of contribution determination, levy scheme, surcharge and calculation of fund size are specified in Schedule 4 to the DPSO.

**63. An ex-ante funding approach is adopted to provide for the operating costs and reserve for absorbing the payout costs.** The target fund size is 0.25 percent of total covered deposits in the banking sector. The DPB is also empowered to impose a surcharge if the fund size falls below 70 percent of the target fund size. In addition, the DPB has secured a standby liquidity facility of HK\$120 billion (US\$15.4 billion) from the Exchange Fund to ensure the adequacy of funding in meeting payout needs.

**64. The MA is empowered, after consultation with the FS, to trigger payment of compensation to the depositors of a failed Scheme member pursuant to the DPSO.** The MA is charged with implementing the decisions of the DPB under the DPSO. If either a Manager has been appointed under section 52 of the BO, or a provisional liquidator has been appointed, in respect of a

Scheme member and the MA is of the opinion that the Scheme member is likely to become unable to meet its obligations then payments may be triggered after consultation with the FS.

## **Effective Market Discipline**

### ***Corporate governance***

**65. The corporate governance regime in HKSAR is founded on a combination of common law, statute and codes of practice.** Common law establishes directors' fiduciary duties and their duty of skill and care, while the CO sets out the rights and obligations of shareholders and officers of the company respectively. In addition, the Companies Registry has issued non-statutory guidelines on Directors' Duties. Companies that are listed on the SEHK are subject to additional requirements under the Listing Rules of the SEHK including, in Appendix 14, a Corporate Governance Code. Listed Issuers are required to include a "corporate governance report" in their annual report. Recent developments include (i) updating of the SEHK Corporate Governance Code in January 2012 (with, among other things, new recommended best practices on Board evaluation of its performance and upgrading of best practices to rules regarding the proportion of independent non-executive directors on the Board); and (ii) passage of a new CO in July 2012 which aims to, among others, enhance corporate governance by strengthening the accountability of directors (including, among others, clarifying in statute the standard of directors' duty of care, skill and diligence); enhancing shareholder engagement in the decision-making process; improving the disclosure of company information; fostering shareholder protection; and strengthen the rights of auditors. The date of coming into force of the new CO was March 2014.

### ***Transparency and financial disclosure***

**66. HKSAR has well-developed arrangements promoting market discipline.** General requirements for disclosure of financial information (i.e., audited annual accounts including balance sheet and profit and loss account) by companies incorporated in HKSAR to their shareholders are set out in the CO. AIs are also subject to the disclosure requirements under the BO, the Banking (Disclosure) Rules made under the BO, and the relevant guidelines laid down by the HKMA. Listed companies are subject to disclosure requirements under the Listing Rules of the Stock Exchange of Hong Kong. The requirement to disclose price sensitive information in a timely manner has had statutory backing under the SFO since January 2013. The SFC has been working closely with Hong Kong Exchanges and Clearing Limited (HKEx) in monitoring the compliance of listed companies with the new statutory regime.

### ***Open and competitive markets***

**67. The policy of the government is not to distort normal market discipline by interfering in commercial decisions.** The government has limited its role to: creating infrastructure and providing an efficient regulatory and administrative environment. There are no "policy loans" required by the government to be made in order to achieve public policy objectives. In the 2013 Index of Economic Freedom compiled by the Heritage Foundation, HKSAR was ranked first in the world for the 19<sup>th</sup> consecutive year.

## E. Supervisory Powers, Responsibilities and Functions

<b>Principle 1</b>	<b>Responsibilities, objectives and powers.</b> An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups. <sup>4</sup> A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorize banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns. <sup>5</sup>
<b>Essential criteria</b>	
<b>EC1</b>	The responsibilities and objectives of each of the authorities involved in banking supervision <sup>6</sup> are clearly defined in legislation and publicly disclosed. Where more than one authority is responsible for supervising the banking system, a credible and publicly available framework is in place to avoid regulatory and supervisory gaps.
Description and findings re EC1	<p>The MA is the sole regulator and supervisor of banking business and deposit-taking activities of AIs in HKSAR as well as being responsible for the authorization of AIs in HKSAR. The office of the MA is known as the HKMA, and the MA is the Chief Executive of the HKMA. Legally, the MA is an individual appointed by the FS under EFO section 5A.</p> <p>The functions of the MA are set out in the BO (section 7). The powers under the BO are vested in the MA and the BO establishes that the MA's principal function is to "promote the general stability and effective working of the banking system" (BO section 7(1)). Further, the MA has the following functions (pursuant to BO section 7(2)):</p> <ul style="list-style-type: none"> <li>(i) supervising compliance with the provisions of the BO (section 7(2)(a));</li> <li>(ii) taking all reasonable steps to ensure AIs are operated in a responsible, honest and business-like manner (section 7(2)(b));</li> <li>(iii) promoting proper standards of conduct and sound and prudent business practices among AIs (section 7(2)(c));</li> <li>(iv) suppressing illegal or improper business practices among AIs (section 7(2)(d));</li> <li>(v) assisting home and overseas supervisors (section 7(2)(e));</li> <li>(vi) proposing reforms to supervisory legislation relating to banking business and deposit-taking business (section 7(2)(f)) ("Banking business" and "deposit" are defined in BO section 2(1)) ; and</li> <li>(vii) taking all reasonable steps to ensure that any banking business, any business of taking deposits, or any other business of AIs is carried on with integrity, prudence and competence and in a manner that is not detrimental, or likely to be detrimental, to the interest of depositors or potential depositors (section</li> </ul>

<sup>4</sup> In this document, "banking group" includes the holding company, the bank and its offices, subsidiaries, affiliates and joint ventures, both domestic and foreign. Risks from other entities in the wider group, for example non-bank (including non-financial) entities, may also be relevant. This group-wide approach to supervision goes beyond accounting consolidation.

<sup>5</sup> The activities of authorising banks, ongoing supervision and corrective actions are elaborated in the subsequent Principles.

<sup>6</sup> Such authority is called "the supervisor" throughout this paper, except where the longer form "the banking supervisor" has been necessary for clarification.

	<p>7(2)(g)).</p> <p>The BO is the primary piece of legislation regulating banking business and providing for the supervision of AIs by the banking supervisory authority (i.e. MA) in HKSAR. An AI is defined as a bank, a restricted license bank or a deposit-taking company. Only AIs are permitted to take deposits. The purpose of the BO is set out in its long title:</p> <p>“To regulate banking business and the business of taking deposits; to make provision for the supervision of AIs so as to provide a measure of protection to depositors; to promote the general stability and effective working of the banking system; to make provision for the supervision of money brokers; and to provide for matters incidental thereto or connected therewith.”</p> <p>The nonbanking financial activities of AIs, for example in securities, insurance and MPFs, fall under the purview of the relevant regulatory authority, e.g., the SFC, the Office of the Commissioner of Insurance (OCI) headed by the IA and the MPFA. However, the MA remains responsible for the “frontline” supervision of AIs in their conduct of non-banking financial activities. The HKMA has established MoUs with the domestic regulators.</p>
<b>EC 2</b>	<p>The primary objective of banking supervision is to promote the safety and soundness of banks and the banking system. If the banking supervisor is assigned broader responsibilities, these are subordinate to the primary objective and do not conflict with it.</p>
Description and findings re EC2	<p>The HKMA is Hong Kong’s central banking institution and is the government authority in Hong Kong responsible for maintaining monetary and banking stability.</p> <p>The HKMA has four main functions:</p> <ul style="list-style-type: none"> <li>• maintaining currency stability within the framework of the Linked Exchange Rate System (EFO sections 3(1) and 5B)</li> <li>• promoting the stability and integrity of the financial system including the banking system (BO section 7(1), CSSO section 9, DPSO section 6(1))</li> <li>• managing the Exchange Fund (EFO section 3(2))</li> <li>• helping to maintain Hong Kong’s status as an international financial centre, including the maintenance and development of Hong Kong’s financial infrastructure (i.e., “with a view to maintaining Hong Kong as an international financial centre, use the Fund as he thinks fit to maintain the stability and the integrity of the monetary and financial systems of Hong Kong.”) (EFO sections 3(1A) and 5B)</li> </ul> <p>The BO provides the legal framework for banking regulation and supervision in HKSAR. As noted under EC1, the functions of the MA are set out in detail in BO section 7, where the MA’s principal function is to “promote the general stability and effective working of the banking system” (BO section 7(1)).</p> <p>The EFO establishes the Exchange Fund under the control of the FS. While, according to the EFO, the Exchange Fund shall be used primarily for affecting the exchange value of the Hong Kong dollar, it may also as noted above (section 3(1A)), be used for</p>

	<p>maintaining the stability and integrity of the monetary and financial systems in HKSAR, with a view to maintaining Hong Kong as an international finance centre. The MA is appointed under the EFO to assist the FS in performing his functions under the EFO and to perform such other functions as are assigned by other Ordinances or by the FS. Powers are delegated by the FS to the MA under the EFO (section 5B) and do not preclude the FS from exercising the powers.</p> <p>In order to provide greater transparency and clarity in relation to the delegation of powers, in June 2003 letters were exchanged between the MA and the FS setting out the division of functions and responsibilities in monetary and financial affairs between them. These letters were drawn up following recommendations made in the 2003 FSAP and are publicly available on the HKMA website. (Please see also CP2, EC1)</p> <p>The letters clarify, inter alia, that responsibility for policies with respect to the stability and integrity of the financial system lie with the FS and that in support of these policies, the MA shall be responsible for issues including:</p> <ul style="list-style-type: none"> <li>(a) providing a measure of protection to depositors and promoting the general stability and effective working of the banking system through regulation of banking business and the business of taking deposits, and the supervision of AIs;</li> <li>(b) determining on his own prudential policies, and standards and guidelines relating to the regulation of banking business and the business of taking deposits;</li> <li>(c) considering and proposing reforms of the law relating to the regulation of banking business and the business of taking deposits;</li> <li>(d) co-operating with other relevant authorities in the supervision of business conducted by AIs (other than banking business or the business of taking deposits).</li> </ul> <p>Further, in relation to the maintenance of Hong Kong as an international financial center, the letters clarify that the MA when discharging his responsibilities for maintaining the stability and integrity of the monetary and financial systems of Hong Kong shall, in cooperation with other relevant organizations, seek to promote:</p> <ul style="list-style-type: none"> <li>• the development of payment, settlement and clearing systems to facilitate the safe and effective conduct of international and cross-border financial activities in HK;</li> <li>• confidence in the monetary and financial systems through active participation in international and central banking forums; and</li> <li>• appropriate market development initiatives that help strengthen the international competitiveness of HK's financial services.</li> </ul>
<b>EC3</b>	Laws and regulations provide a framework for the supervisor to set and enforce minimum prudential standards for banks and banking groups. The supervisor has the

	power to increase the prudential requirements for individual banks and banking groups based on their risk profile <sup>7</sup> and systemic importance. <sup>8</sup>
Description and findings re EC3	<p>The BO provides the legal framework for the prudential regulation and supervision of AIs by the MA. In addition, the BO provides the basis and mechanism for the MA to set and enforce prudential standards which reflect the objectives and functions of the MA under the Ordinance.</p> <p>The BO itself contains various statutory requirements and limits with which AIs must comply, including those in relation to capital adequacy; liquidity; large exposure and related party exposure limits; and limits on shareholdings and holdings of interests in land.</p> <p><i>Rulemaking</i> The MA is able (under BO section 7(2)(f) and section 7(3)) to consider and propose reform of the law relating to banking business and the business of taking deposits and gazette guidelines.</p> <p><u>Capital, liquidity and disclosure:</u> The MA has certain rule making powers under the BO relating to capital, liquidity and disclosure. Rules made by the MA under these powers are subsidiary legislation and, as such, are subject to negative vetting by the Legislative Council (LegCo). The MA has to date made rules on capital requirements for, and disclosure by, AIs (BO sections 97C and 60A). In the future, the MA will have the power to make rules on liquidity requirements (once section 97H of the BO is brought into effect for the purposes of implementing the Basel 3 Liquidity Coverage Ratio). This rule-making is subject to consultation with the FS, the Banking Advisory Committee, the DTC Advisory Committee, The Hong Kong Association of Banks and The DTC Association. In making rules, the MA may differentiate between different classes of AIs; may give effect to Basel Committee standards in whole or in part and subject to such modifications as the MA thinks fit having regard to circumstances in HKSAR; and may prescribe a capital requirement in the form of a range with upper and lower limits.</p> <p>At the time of the assessment, the MA was preparing to issue rules under the BO section 97C to implement the Basel 3 capital conservation buffer and Countercyclical Capital Buffer (CCyB) and to impose the Global Systemically-Important Bank (G-SIB) and Domestic Systemically-Important Bank (D-SIB) “higher loss absorbency” capital surcharges.</p> <p><u>Authorization, revocation, minimum deposits and tribunals.</u> The Chief Executive in Council (by virtue of BO section 135(1)) may amend BO Schedules (1, 7, 8 and 15) relating to authorization, revocation, minimum deposits and tribunals. The FS (by virtue of BO section 135(3)) may amend the Schedules relating to Liquidity, advertising,</p>

<sup>7</sup> In this document, “risk profile” refers to the nature and scale of the risk exposures undertaken by a bank.

<sup>8</sup> In this document, “systemic importance” is determined by the size, interconnectedness, substitutability, global or cross-jurisdictional activity (if any), and complexity of the bank, as set out in the BCBS paper on *G-SIBs: assessment methodology and the additional loss absorbency requirement*, November 2011.



	<p>managers and money brokers (Schedules 4, 5, 9, 11, 12 and 14).</p> <p><i>Guidelines.</i> Under the BO (section 7(3)) the MA may issue statutory guidelines indicating how the MA will exercise his functions under the BO and in particular, under section 16(10) the MA may also issue guidelines indicating how he will exercise his functions relating to the grant or refusal of authorization and the ongoing authorization criteria in the BO Schedule 7. The MA may also issue guidelines (section 82(1)) to specify business practices which should not be engaged in by AIs because they will or may increase single-party concentration risk; and, in the case of BO section 92(6), to specify the factors the MA takes into account when determining whether advertising for deposits has taken place. Guidelines must be published in the Gazette.</p> <p><i>Supervisory Policy Manual (SPM) and other guidance</i> The BO is supplemented by the SPM, which comprises:</p> <ul style="list-style-type: none"> <li>• <i>statutory guidelines</i> issued under BO (including under sections 7(3) and 16(10)), which set out the minimum standards with which AIs are expected to comply to satisfy the requirements of the BO. In addition to minimum standards, statutory guidelines may also embody advisory standards and best practices;</li> <li>• <i>non-statutory guidance notes</i> which set out recommendations in respect of standards which AIs should aim to achieve; and</li> <li>• <i>technical notes</i> which clarify the HKMA's interpretation of regulatory and reporting matters.</li> </ul> <p><i>Circular letters.</i> In addition to the above, the HKMA may issue circulars or circular letters to provide guidance and recommendations to AIs on specific issues.</p> <p><i>Banking groups and consolidation</i> The MA has the power to impose prudential standards on a consolidated basis (see CP12) but does not have specific powers to set and enforce minimum prudential standards on bank holding companies of AIs incorporated in HKSAR unless the bank holding company is itself a bank, restricted license bank or deposit-taking company (i.e. "AIs" or AIs as defined in BO section 2(1)). The MA, does, however have powers under the BO to approve the bank holding companies as controllers of AIs (BO section 70), to obtain information from bank holding companies (BO section 63(2A)) and to impose conditions (BO section 70 conditions) on these companies when authorizing them as controllers of AIs under BO section 70(2), (6) and (7) (which powers have been used to ensure controllers have adequate resources / strength).</p> <p><i>Individual capital and liquidity requirements</i> The MA may (under BO section 97F) vary any capital requirement rule for individual AIs if the MA is satisfied, on reasonable grounds, that it is prudent to make the variation, taking into account the risks associated with the AI. This power is exercised through the Supervisory Review Process / CAMEL review process and each AI is subject to an individual minimum capital requirement reflecting its risk profile which takes into account the nature and scale of the AI's business and its role in the financial system. The FS, (under BO section 102(4)) can vary the minimum 25 percent liquidity ratio for all AIs on a system wide basis and the MA may (under BO section 105(1)) vary the</p>
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	<p>minimum liquidity ratio applicable to any individual AI.</p> <p><i>Enforcement of prudential standards</i></p> <p>If an AI fails to comply with the capital or liquidity requirement, the AI and the MA must discuss what remedial measures should be taken by the AI. Importantly, the MA is not “bound” by these discussions and may, thereafter, by notice in writing require the AI to take remedial action specified in the notice. If the AI fails to comply with the requirements, every director, chief executive and manager (these positions are subject to definition under the BO) commits an offence and is liable to fines and imprisonment.</p> <p>Ultimately, though subject to consultation with the FS, the MA has broad-ranging supervisory intervention powers under BO section 52. This section empowers the MA, after consultation with the FS, to seek to contain and remedy a crisis situation if an AI has contravened or failed to comply with any of the provisions in the BO; or is carrying on its business in a manner detrimental to the interests of its depositors; or the MA’s powers of revocation have become exercisable. (See CP1 EC6 and CP 11)</p> <p>Failure to adhere to the guidance, whether statutory or non-statutory, may call into question whether the AI concerned continues to satisfy the minimum criteria for authorization under the BO. Where such failure relates to statutory guidelines, it may also constitute a contravention of the relevant provision of the BO. The assessors confirmed with all firms and professionals with whom they met that the SPM, Guidelines and Circulars are perceived and treated as enforceable rules by the AIs and not least because there is a clear understanding of how the breach of an SPM can and will be quickly escalated.</p>
<b>EC4</b>	<p>Banking laws, regulations and prudential standards are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices. These are subject to public consultation, as appropriate.</p>
Description and findings re EC4	<p>The BO (section 7(2)(f)) explicitly recognizes that one of the MA’s functions is to consider and propose reforms of the law relating to banking business and the business of taking deposits. This responsibility is noted in the exchange of letters between the FS and MA referred to in EC 2 above.</p> <p>When proposing amendments to the BO, the MA (as a matter of practice) consults the FS, the Banking Advisory Committee, the DTC Advisory Committee, the Hong Kong Association of Banks and the DTC Association. Following such consultation, the MA will submit an amendment bill to the Legislative Council for approval and the amendments are published in the Hong Kong Government Gazette.</p> <p>The MA may also, after consultation with the FS, the Banking Advisory Committee, the DTC Advisory Committee, The Hong Kong Association of Banks and The DTC Association, make rules prescribing requirements for disclosure, capital and liquidity (rules on liquidity will come into force when BO Part XVIB comes into operation).</p> <p>Rules (and amendments to Rules) made pursuant to the BO are subsidiary legislation as noted above and are subject to negative vetting by the Legislative Council (LegCo). In other words the LegCo has power of objection. The authorities noted that in the</p>

	<p>case of amendments pursuant to Basel 2, LegCo permitted the amendments to pass without comment. In the case of the Basel 3 proposed amendments however, the LegCo has created a sub-committee to consider the proposals carefully. The authorities commented that this process has facilitated a broader consideration of the proposals and the impact of the proposals in a wider context.</p> <p>The MA also has powers to issue new or revised SPM modules as appropriate to reflect changing regulatory norms and supervisory expectations and practices. SPM modules are updated or issued from time to time to implement guidance published by the Basel Committee, FSB and other supervisory standard-setting bodies. It is the standard practice of the HKMA to consult with the Banking Advisory Committee, the DTC Advisory Committee, The Hong Kong Association of Banks and the DTC Association during the course of preparation and issuance of an SPM module.</p> <p>The MA periodically proposes amendments to the BO and makes amendments to the rules made under it (BCR and BDR) to keep them in line with relevant international standards and address any evolving practices. The BO and the BCR were amended in 2012 to provide the legal framework for the introduction of Basel 3. Amendment was also made to the BDR in 2013 to implement the corresponding Pillar 3 requirements associated with Basel 3 implementation. The HKMA has updated or issued new 15 SPM modules between 2009 and 2012.</p>
<b>EC5</b>	<p>The supervisor has the power to:</p> <ul style="list-style-type: none"> <li>(a) have full access to banks' and banking groups' Boards, management, staff and records in order to review compliance with internal rules and limits as well as external laws and regulations;</li> <li>(b) review the overall activities of a banking group, both domestic and cross-border; and</li> <li>(c) Supervise the activities of foreign banks incorporated in its jurisdiction.</li> </ul>
Description and findings re EC5	<p><i>a) Information-gathering powers under the BO</i></p> <p>The HKMA has extensive information gathering powers under the BO, which in the case of locally incorporated AIs apply to any branch or subsidiary of the AI. Failure to comply with required information can result in an offence that is liable to fines and imprisonment of directors, chief executives and managers of the AI. Information gathering powers include the following:</p> <p>Under BO sections 55 and 56, the MA may examine the books, accounts and transactions of the AI (and any local branch, local office, overseas branch, overseas representative office or subsidiary (whether in or outside HKSAR) if the AI is locally incorporated) and must be granted access to such books and information and facilities as needed for the examination.</p> <p>BO sections 63(2) and (2A) extend the information gathering powers. The MA may require an AI, an AI's holding company, any subsidiary of any such holding company, or any subsidiary of an AI to submit such information as the MA may reasonably require for the exercise of his functions under the BO.</p> <p>BO section 72A(2) empowers the MA to require a specified person to submit such</p>

information as he may reasonably require for the exercise of his functions under the BO. As defined in BO section 72A(1), "specified person" is any person proposing to become a controller of an AI incorporated in HKSAR, any person who is the chief executive of an AI, any person who is an executive officer or relevant individual of an AI that is registered for securities business, any person who is a director or controller of an AI incorporated in HKSAR and anyone seeking the MA's consent to become a chief executive, director or executive officer.

The MA also has similarly broad information-gathering powers under the MPFSO, SFO and AMLO for the purposes of inspection and investigation in terms of gaining access to premises and requiring records to be made available.

The HKMA has not experienced any difficulties in accessing an AI's Board when necessary. The HKMA also has access to AIs' management, staff, internal records, accounts, policies and procedures and files in order to conduct on-site examinations and off-site reviews.

(See also CP10, EC7.)

*(b) Review the overall activities of a banking group*

In addition to the widely drawn information powers noted above, which permit the HKMA to review the activities of the banking group overall, if considering expansion, a locally incorporated AI must obtain approval from the HKMA in order to establish or acquire a branch or overseas banking subsidiary or major investment and acquisition and such approval may have conditions attached to it (see BO sections 44(4) and (5), 49(4) and (5), 51A(4) and (5) and 87A(4) and (5)). As part of its assessment of such group expansions the HKMA will assess whether there would be any impediment to the effective supervision or consolidated supervision of the group – such as confidentiality constraints or impediments to the HKMA's ability to conduct on-site examinations. There are no jurisdictions in which branches or subsidiaries of locally incorporated AIs are located in which the HKMA cannot conduct an on-site review.

Locally incorporated AIs with overseas operations are required to report various banking returns on a solo basis, and where applicable, on a consolidated basis, i.e. based on the following positions:

- position of Hong Kong offices;
- position of overseas branches in each country;
- combined position including all local and overseas branches;
- consolidated position (including all subsidiaries specified by the HKMA).

The HKMA may require an AI to submit additional information on its overseas operations or its group. The HKMA schedules overseas examinations of AIs' overseas operations on a periodic basis as part of its ongoing consolidated supervision of AIs. 15 overseas on-site examinations were conducted in 2012.

*(c) Supervise the activities of foreign banks incorporated in its jurisdiction.*

An AI that is incorporated locally is subject to the full suite of the HKMA's powers and

	<p>supervisory processes, even when it has foreign ownership. In terms of review of upstream group structures the BO (Schedule 7) provides that the MA must be in the position of being able to satisfy itself on a continuous basis that the controller(s) of the AI is fit and proper. It is through this avenue—i.e., a suitability assessment of a controller – that the MA has the legal power to determine whether full and sufficient access to group information is available on a continuing basis.</p> <p>In 2013, the HKMA implemented an enhanced framework for the consolidated supervision of banking groups to obtain an adequate degree of oversight over the holding companies of locally incorporated licensed banks (local banks) based on the MA's power to attach conditions to the consent given for them to be / become majority shareholder controllers of local banks (under BO section 70). This framework applies to cases where no holding company of a local bank is a regulated entity. (See also CP1 EC3 and CP12)</p>
<p><b>EC6</b></p>	<p>When, in a supervisor's judgment, a bank is not complying with laws or regulations, or it is or is likely to be engaging in unsafe or unsound practices or actions that have the potential to jeopardize the bank or the banking system, the supervisor has the power to:</p> <ul style="list-style-type: none"> <li>(a) take (and/or require a bank to take) timely corrective action;</li> <li>(b) impose a range of sanctions;</li> <li>(c) revoke the bank's license; and</li> <li>(d) cooperate and collaborate with relevant authorities to achieve an orderly resolution of the bank, including triggering resolution where appropriate.</li> </ul>
<p>Description and findings re EC6</p>	<p><i>(a) take (and/or require a bank to take) timely corrective action</i></p> <p>The MA has powers under the BO to serve a written notice on an AI requiring it to take remedial action specified in the notice in relation to contravention of requirements for capital and liquidity. However, the MA must first hold discussions with the AI before serving the notice but the MA is not bound by any such discussions. Further, the AI has a period of 30 days (or such longer period as the Banking Review Tribunal may allow in the circumstances of the particular case) after receipt of the notice during which it may apply to the Banking Review Tribunal for a review of the decision. However, the submission of an application does not suspend the decision.</p> <p>The authorities confirmed that the discussions with the AIs are the opportunity to clarify and confirm facts with the AI in question as well as ensuring that the AI is fully aware of the concerns and proposed course of action. No decision has ever been referred to the Review Tribunal.</p> <p>Furthermore, under section 52(1) of the BO, the MA, after consultation with the FS may exercise the following powers under certain circumstances to address issues which potentially jeopardize the AI's safety and soundness:</p> <ul style="list-style-type: none"> <li>• require an AI to take any action or to do any act or thing whatsoever in relation to its affairs, business and property as the MA considers necessary. This may include, inter alia, restrictions imposed on the AI's businesses and restrictions on the AI's relationship with other members of its group ;</li> <li>• appoint an Advisor to advise an AI on the management of its affairs, business</li> </ul>

	<p>and property;</p> <ul style="list-style-type: none"> <li>• appoint a Manager to manage such of the AI's affairs, business and property as the MA may specify; or</li> <li>• make a report on an AI to the Chief Executive in Council; thereafter, the Chief Executive in Council may, following receipt of the report, direct the FS to present a petition to the Court of First Instance for the winding up of the AI.</li> </ul> <p>To date the HKMA's experience is that AIs are responsive to its requirements for remedial measures when the HKMA raises serious concerns, prior to the exercise of formal powers. The MA's broad intervention powers under the BO (section 52) in addition to the risk that senior management might be found to be not fit and proper provide a clear incentive structure for AIs to comply with MA demands. In the past, for example, AIs have agreed to limit their business expansion or restrict certain of their activities (e.g., deposit-taking) given significantly increasing risks or patently unsatisfactory systems of control; and senior management have voluntarily resigned their posts when the MA has raised issues regarding their fitness and propriety. The assessors saw files which confirmed these actions.</p> <p><i>(b) impose a range of sanctions</i></p> <p>In addition to the measures noted above, the MA has the following powers:</p> <ul style="list-style-type: none"> <li>• to impose conditions on the authorization of an AI as the MA may think proper (BO section 16(5)). Any conditions must be consistent with the purpose of the BO as set out in its long title (please see EC1).</li> <li>• to withdraw consent from the chief executive of an AI or a director of an AI incorporated in HKSAR if the MA has ceased to be satisfied that the chief executive or director is fit and proper to hold such position (BO section 71(4)) and the power to attach conditions to the consent (BO section 71(5)).</li> <li>• to remove or suspend, after consultation with the SFC, a relevant individual who is, or was at any time, guilty of misconduct or in the MA's opinion is not, or has ceased to be, a fit and proper person in his capacity as that type of relevant individual (BO section 58A). The term "misconduct" means a contravention of relevant statutory provisions or conduct relating to the carrying on of any regulated activity by the AI which is or is likely to be prejudicial to the interest of the investing public or to the public interest.</li> <li>• to withdraw or suspend the consent granted to an executive officer of an AI, after consultation with the SFC, where the executive officer is or was at any time, guilty of misconduct or, in the MA's opinion, is not a fit and proper person to be such type of officer (BO section 71C).</li> </ul> <p>In the past 5 years, the MA has referred a number of cases involving suspected offences under the BO to the Department of Justice of the HKSAR for consideration as to whether to prosecute. The MA has taken disciplinary sanctions against 5 relevant individuals in the past 5 years under BO section 58A.</p> <p><i>(c) revoke the bank's license</i></p> <p>The MA, subject to consultation with the FS, may under Part V of the BO (section 22) propose the revocation of the authorization of an AI based on any of the grounds for</p>
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	<p>revocation which are set out in Schedule 8. Under Part VI of the BO, the MA may suspend the authorization of an AI.</p> <p>Failure to comply with any provisions of the BO or SPM or other guidelines, whether statutory or non-statutory, issued by the MA, as well as unsafe or unsound practices or actions, may call into question whether the AI concerned continues to satisfy the minimum authorization criteria set out in the BO Schedule 7. This could constitute a ground for revocation under BO Schedule 8.</p> <p>There has been 1 case in the last 5 years in which the MA, after consultation with the FS, has exercised power to revoke an AIs' authorization after becoming satisfied that certain grounds set out in the BO Schedule 8 had been met.</p> <p><i>(d) cooperate and collaborate with relevant authorities to achieve an orderly resolution of the bank, including triggering resolution where appropriate.</i></p> <p><i>Domestic coordination</i></p> <p>The MA is the authority responsible for triggering and undertaking resolution actions regarding AIs incorporated in HKSAR or in support of overseas resolution authorities with respect to AIs incorporated outside of HKSAR, subject to the conditions and limits provided in BO sections 52(1)D and 122 with respect to winding up an AI. The MA, after consultation with the FS, may exercise the powers under BO section 52.</p> <p>Under BO section 122(2), the FS, acting in accordance with a direction of the Chief Executive in Council may apply to Court to wind up an AI. Where a person other than the FS (e.g., an overseas resolution authority) petitions to wind up an AI, the MA is entitled to be heard on the petition.</p> <p>While the BO (section 120(1)) imposes secrecy obligations, the MA may disclose information where it is necessary for the exercise of any function under the BO. The MA may disclose information to relevant local authorities (i.e. the FS, SFC, IA, MPFA, FRC, and the Hong Kong DPB) to assist them in the exercise of their functions, provided that it is not contrary to the interest of depositors or public interest.</p> <p>Domestic coordination in respect of orderly resolution is expected to be further enhanced following legislative reform that is planned in order to comply with the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions. At the time of the assessment a sequence of consultations in 2014 that should result in amended legislation was planned.</p> <p><i>Cross border coordination</i></p> <p>To the extent the MA is considered to exercise resolution functions, he can disclose information to resolution authorities exercising similar functions overseas provided the following conditions are met (BO section 121):</p> <ul style="list-style-type: none"> <li>• the authority concerned is subject to adequate secrecy provisions; and</li> <li>• it is desirable or expedient that information should be so disclosed in the interests of depositors or potential depositors or the public interest; or</li> </ul>
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	<ul style="list-style-type: none"> <li>such disclosure will enable or assist the recipient of the information to exercise its functions and disclosure is not contrary to the interests of depositors or potential depositors or the public interest.</li> </ul> <p>Within the past five years, the MA has exercised his powers under BO section 52(1)(A) to impose restrictions on the affairs, business and property of a foreign owned establishment in HKSAR. The acquisition of the bank's global activities, transfer of assets and liabilities as well as the revocation of the authorization were facilitated by the cross border cooperation and collaboration between relevant authorities. The authorities noted that in such circumstances an early understanding of the scope of each others' powers was critical in facilitating effective progress.</p> <p><i>Branches of overseas incorporated AIs</i></p> <p>The powers to revoke, suspend and impose conditions on an AI's authorization under the BO apply equally to Hong Kong branches of overseas incorporated AIs as they do to locally incorporated AIs. With respect to cross border resolution, an AI may only establish a branch in HKSAR if the HKMA is satisfied that conditions are in place to facilitate effective cross border coordination in supervision, including in relation to remedial actions.</p>
<b>EC7</b>	The supervisor has the power to review the activities of parent companies and of companies affiliated with parent companies to determine their impact on the safety and soundness of the bank and the banking group.
Description and findings re EC7	The MA has powers under the BO (section 63(2A)) to obtain information on any holding company of an AI, any subsidiary of any such holding company or any subsidiary of an AI for review (see also EC5). Moreover, the approval of an AI's controllers may be subject to conditions, including with regard to reporting requirements (BO section 70(2)(b)). The HKMA monitors relevant information on AIs' holding companies and key related companies of such holding companies in order to identify any possible contagion risk that AIs may face as a result of any adverse developments in respect of their group companies.
<b>Assessment of Principle 1</b>	Compliant
Comments	<p>The responsibilities and objectives of the HKMA related to banking supervision are both clear and comprehensive, supported by an underlying statutory framework. In using the Exchange Fund, the HKMA may have a view to maintaining Hong Kong's status as an international financial centre, but the Exchange Fund may only be used to support development if this will maintain the stability and the integrity of the monetary and financial systems of Hong Kong.</p> <p>It is clear from discussions with the authorities, supported by the exchange of letters between the MA and FS in 2003, that the HKMA mandate is interpreted in terms of promoting financial stability and ensuring a high quality of regulatory and supervisory standards, as well as robust, up to date financial market infrastructure. It is also clear that despite references to a regard for the status of Hong Kong as an international financial center this concept is subsidiary to the mandate for financial stability. In other words, the authorities are strongly committed and required to deliver the highest regulatory and prudential standards.</p>



	<p>However, the authorities should be mindful of the need to avoid any “objectives creep” such that competitive considerations in promoting Hong Kong as an international financial centre risk being viewed as an objective in their own right, decoupled from the financial stability objective. As demonstrated and experienced in other financial centers, the potential exists for a conflict between objectives focused on dimensions of both stability and the status of a financial centre and 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 in order to maintain Hong Kong’s status as a vibrant open market.</p>
<b>Principle 2</b>	<p>Independence, accountability, resourcing and legal protection for supervisors. The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor.</p>
Essential criteria	
<b>EC1</b>	<p>The operational independence, accountability and governance of the supervisor are prescribed in legislation and publicly disclosed. There is no government or industry interference that compromises the operational independence of the supervisor. The supervisor has full discretion to take any supervisory actions or decisions on banks and banking groups under its supervision.</p>
Description and findings re EC1	<p><i>Operational independence</i></p> <p>The HKMA enjoys operational de facto independence but this is not underpinned by the law. The MA is a public officer appointed by the FS under EFO section 5A and, in addition to assisting the FS in the performance of his functions under the EFO, the MA is required to perform functions imposed on, or assigned to, him by any other Ordinance (e.g., the BO) and to perform such functions as the FS may direct. Specifically, the MA exercises the supervisory powers set out in the BO. However, prior consultation with (albeit not prior approval from) the FS is necessary for some major decisions (such as intervention or revocation of authorization under BO sections 52 and 22). Further, the BO (section 10) reserves the right of the Chief Executive of HKSAR to give directions to the FS and the MA which are consistent with the objectives and specific powers and duties contained in the BO.</p> <p>In discussion it is clear that the authorities regard section 10 as an emergency power for the Chief Executive of HKSAR and this power has never been used. In order to exercise rights under section 10, the Chief Executive of HKSAR must act in a manner consistent with the purpose of the BO and any decision would be subject to judicial review and would be vulnerable to reversal if not in conformity with the purpose and objective of the BO. To override and direct the MA, whose powers and responsibilities are prescribed by the LegCo, would be a very serious step and underlined (a) the extreme unlikelihood of the power being exercised and (b) the fact that use of the power would be in cases of extreme emergency.</p> <p>In order to provide further clarity on the division of functions and responsibilities between the FS and the MA, there was a public exchange of letters between the FS</p>

and the MA in June 2003. The letters state that the BO provides the MA with the legal basis for the regulation and supervision of banking business and the business of taking deposits and that the FS, assisted by the SFST, is responsible for policies for the maintenance of the stability and integrity of the financial system of Hong Kong.

In support of these policies, it is stated that the MA shall be responsible for, among other things, the following:

- (a) providing a measure of protection to depositors and promoting the general stability and effective working of the banking system through regulation of banking business and the business of taking deposits, and the supervision of AIs;
- (b) determining on his own prudential policies, and standards and guidelines relating to the regulation of banking business and the business of taking deposits;
- (c) considering and proposing reforms of the law relating to the regulation of banking business and the business of taking deposits;
- (d) co-operating with other relevant authorities in the supervision of business conducted by AIs (other than banking business or the business of taking deposits).

Under the exchange of letters, the FS sets out the powers delegated by the FS to the MA under the EFO, Legal Tender Notes Issue Ordinance and The Hong Kong Association of Banks Ordinance. Since the MA's supervisory powers derived from the BO are conferred on him personally, the issue of delegation from the FS or any other public officer regarding powers under the BO does not arise in the context of the exchange of letters.

The HKMA has autonomy in relation to its day-to-day operations and in the methods it uses to pursue policy objectives determined by the HKSAR Government. Although it is subject to override and consultation as noted above, there is no evidence of interference from any party which compromises the operational independence of the HKMA.

The operations of the HKMA are funded by the Exchange Fund which is a discrete government fund designated for specified purposes and controlled by the FS in consultation with the EFAC as required by the EFO (See also EC4). The HKMA, under the delegated authority of the FS manages and uses the Fund in accordance with the EFO.

*Accountability*

The HKMA is directly accountable to the FS pursuant to the EFO (section 5A) and BO (section 9) which specifies the annual reporting obligations to the FS. Though not specifically required by law, the MA periodically provides briefings to the Legislative Council (LegCo) Panel on Financial Affairs (FAP) to explain the work of the HKMA and to answer questions. The MA also attends FAP briefings with the FSTB when primary or subsidiary legislation is to be introduced into LegCo relating to matters within the HKMA's purview and attends Bills/Sub-committees (with FSTB) as the legislative

	<p>process progresses through LegCo. The FSTB is the Government policy bureau with responsibility for policies for maintaining the stability and integrity of Hong Kong's financial system and the status of Hong Kong as an international financial centre. The FSTB is also responsible for steering legislation relating to banking regulation and supervision through the LegCo.</p> <p><i>Governance</i></p> <p>The HKMA does not have a board per se, but the Exchange Fund Advisory Committee (EFAC) carries out many of the functions of a management board for the HKMA. The EFAC was established under EFO for the purpose of advising the FS on matters related to the control of the Exchange Fund. The FS is the ex officio chairman of EFAC and the other members are appointed by the FS under the delegated authority of Chief Executive of the HKSAR Government.</p> <p>The EFAC has a mandate, underpinned by the EFO, to oversee the performance, remuneration policy, budgetary issues and adequacy of internal controls of the HKMA. The members of the EFAC are appointed ad personam for the expertise and experience (e.g., knowledge of financial and economic affairs) that they can bring to the committee. Current members consist of representatives from the accounting, legal, business, academic and banking fields. There are five sub-committees of the EFAC some of which, such as the Governance Sub-Committee (the Sub-Committee does not include any members from the banking sector to avoid potential conflict of interest) and Audit Sub-Committee, have an oversight role over the HKMA.</p> <p>The terms of reference of the Governance Sub-Committee, which are publicly available on the HKMA website, are:</p> <ol style="list-style-type: none"> <li>(1) To monitor the performance of the HKMA in carrying out its functions and responsibilities and in its use of resources, and to formulate recommendations to the FS through the Exchange Fund Advisory Committee (EFAC) on:       <ol style="list-style-type: none"> <li>(a) the remuneration and human resources policies of the HKMA;</li> <li>(b) remuneration for HKMA staff, taking account of the Sub-Committee's assessment of the quality and effectiveness of the HKMA's work; and</li> <li>(c) the use of resources of the HKMA, including its annual administrative budget.</li> </ol> </li> <li>(2) To consider recommendations and provide advice to the FS on the appointment and dismissal of staff at the level of Executive Director and above.</li> <li>(3) To keep under review the governance arrangements for the HKMA and to make recommendations to the FS through EFAC as appropriate.</li> </ol> <p>Thus the tasks of the Sub-Committee include monitoring the performance of the HKMA in carrying out its functions and responsibilities and its use of resources, as well as formulating recommendations on remuneration and use of resources and advising the FS on senior level appointments within the HKMA. The Governance Sub-Committee is also responsible for keeping under review the governance arrangements of the HKMA. The EFAC Governance Sub-Committee's terms of reference, as noted above, do not include the explicit responsibility for setting or agreeing the strategic objectives of the HKMA although it will consider such issues in the context of its review</p>
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	<p>of performance objectives, annual budgets and three year plans for the HKMA.</p> <p>The Internal Audit Division of the HKMA assists the senior management of the HKMA in the effective discharge of its responsibilities and functions and regularly reports to the EFAC Audit Sub-Committee. The mission, objectives, scope, authority and accountability of the Internal Audit Division is defined under the Internal Audit Charter of the HKMA.</p> <p>The HKMA seeks to maintain a high degree of transparency in respect of its operational independence, accountability and governance structure through public disclosures via various channels including annual reports and website (with e.g., presentation materials for briefings to LegCo available on the HKMA website).</p>
<b>EC2</b>	<p>The process for the appointment and removal of the head(s) of the supervisory authority and members of its governing body is transparent. The head(s) of the supervisory authority is (are) appointed for a minimum term and is removed from office during his/her term only for reasons specified in law or if (s)he is not physically or mentally capable of carrying out the role or has been found guilty of misconduct. The reason(s) for removal is publicly disclosed.</p>
Description and findings re EC2	<p>The MA, who is the Chief Executive of the HKMA, is appointed by the FS under EFO section 5A(1) on such terms and conditions as the FS thinks fit.</p> <p>The existing MA is appointed for a term of 5 years. The term was determined by the FS after consultation with the EFAC Governance Sub-Committee. On the occasion of the last appointment of the MA, the FS convened an expert panel of three individuals to give advice and make recommendations.</p> <p>The FS is vested with the power to dismiss, remove or revoke the appointment of the MA (IGCO section 42). However, there is no statutory provision that specifies the circumstances under which the MA can be removed from his office. As with the other staff members of the HKMA, the MA can be removed from office according to the provisions set out in the MA's letter of appointment. 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; bankruptcy. In common with all other members of the MA's staff, his employment may be terminated for "gross misconduct."</p> <p>The HKMA makes public announcements of all staff changes at the level of Executive Director or above. As a matter of good practice, but not due to legal obligation, the reasons for these staff changes are also publicly disclosed.</p>
<b>EC3</b>	<p>The supervisor publishes its objectives and is accountable through a transparent framework for the discharge of its duties in relation to those objectives.<sup>9</sup></p>
Description and findings re EC3	<p>The MA's responsibilities are set out in the exchange of letters headed "Functions and responsibilities in Monetary and Financial Affairs" which is published on the HKMA's</p>

<sup>9</sup> Please refer to Principle 1, Essential Criterion 1.

	<p>website.</p> <p>The BO requires the MA to send an annual report to the FS on the working of the BO and the activities of his office (section 9(1)). The FS may publish the report as he thinks fit (under section 9(5)). The annual report of the HKMA describes the legal mandate, including powers, functions and responsibilities, of the MA as set out in the BO and EFO as well as the HKMA's achievements during the year and plans for the coming year. The chapter on banking stability in the annual report generally forms the report on the working of the BO and the activities of the HKMA that is submitted by the MA to the FS in accordance with BO section 9(1).</p> <p>The MA briefs the LegCo, through the LegCo FAP, on the full range of his work several times a year. The materials presented to the LegCo FAP are available to the public through the HKMA's website and indeed meetings are televised. The MA also responds to questions in respect of his duties raised from time to time by the LegCo members. The authorities indicated that they perceive the briefings to be beneficial in terms of public communication as well as facilitating policy development. The briefing sessions are useful, when legislative amendments or policy initiatives need to be brought forward because there is an informed awareness of the context out of which proposals are made.</p> <p>Each year the banking side of the HKMA holds a press conference to discuss its activities over the past year and to introduce its priorities and areas of key supervisory focus for the coming year. Such information is posted on the website.</p> <p>In order to plan for the medium to longer term, the HKMA draws up a three-year plan which is approved by the FS on the advice of the EFAC (via the Governance Sub-Committee of EFAC). The three-year plan includes major initiatives or tasks (with justifications) to be undertaken in the next three years.</p> <p>The EFAC Governance Sub-Committee is responsible for monitoring the performance of the HKMA in carrying out its functions and responsibilities and its use of resources, and for formulating recommendations to the FS through the EFAC on the use of resources of the HKMA, the remuneration and human resources policies of the HKMA, as well as remuneration for HKMA staff, taking account of the Sub-Committee's assessment of the quality and effectiveness of the HKMA's work. It also keeps the governance arrangements of the HKMA under review. The HKMA reports its work to the EFAC Governance Sub-Committee regularly during the year.</p>
<b>EC4</b>	<p>The supervisor has effective internal governance and communication processes that enable supervisory decisions to be taken at a level appropriate to the significance of the issue and timely decisions to be taken in the case of an emergency. The governing body is structured to avoid any real or perceived conflicts of interest.</p>
Description and findings re EC4	<p><i>Internal authorizations</i></p> <p>The HKMA has a set of internal authorizations that specify which staff within the HKMA is entitled to exercise the powers conferred on the MA under the different sections of the ordinances relevant to the work of the MA. The authorizations are updated from time to time and approved by the MA.</p>

	<p><i>Flow of information</i></p> <p>There is a structure of regular internal meetings to ensure that information on outstanding issues is disseminated to the appropriate levels of staff. Minutes of meetings record decisions on policy lines as well as on follow up actions which can be monitored. The authorities indicated that they felt the flow of information was efficient and could be escalated quickly should need arise. Additionally, any member of the banking staff may, and is expected to, exercise his/her judgment to escalate a banking issue to his/her senior immediately. The assessors were able to review some examples of such minutes.</p> <p>Meetings are held at multiple levels within the organization from divisional to departmental level. There are also bi-weekly Senior Staff Meetings between the Deputy Chief Executive (Banking) (DCE(B)) who is responsible for banking regulation and supervision and all Executive Directors (Banking) and the Division Heads (Banking) and bi-weekly Banking Side Meetings between the Senior Staff Meeting members and the MA.</p> <p><i>Crisis management and decision making</i></p> <p>In the event of a crisis at an individual bank or at the banking system level, the HKMA has in place an internal set of documents (referred to as the "contingency plan") describing the procedures and measures which can be taken by the HKMA in handling banks experiencing various forms of distress, together with the duties and responsibilities of the banking staff who should be involved.</p> <p>Under the contingency plan procedures, the internal Banking Supervision Review Committee (BSRC) is convened to consider and advise on potential actions to deal with the situation. This is an internal practice of the HKMA and the MA may exercise his powers under the BO, without convening the BSRC, if the circumstances so warrant. The BSRC also covers advice on the exercise of powers under the BO including the granting, suspension and revocation of the authorization of AIs; consideration of representations from AIs or persons in response to proposed regulatory actions; and cases involving a serious breach of penal BO provisions. Additionally, the BSRC advises on the handling of a banking crisis and other important regulatory and supervisory issues.</p> <p>The BSRC is chaired by the DCE(B), and all of the Executive Directors and certain Division Heads of the Banking Departments are members. The General Counsel also attends BSRC meetings to provide legal advice. The MA may chair BSRC meetings if circumstances suggest urgency or importance. The BSRC has been convened on a very limited number of occasions in recent years since the peak of the financial crisis to deal with AI-specific problems.</p> <p><i>The EFAC Governance Sub-Committee</i></p> <p>As noted under EC1, there is no governing board per se for the HKMA and the EFAC (primarily through its Governance Sub-Committee) performs the role of monitoring the performance of the HKMA and its use of resources. In order to avoid any conflict of interest, the EFAC Governance Sub-Committee does not include any members from</p>
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	the banking sector.
<b>EC5</b>	The supervisor and its staff have credibility based on their professionalism and integrity. There are rules on how to avoid conflicts of interest and on the appropriate use of information obtained through work, with sanctions in place if these are not followed.
Description and findings re EC5	<p>The HKMA seeks to ensure the professionalism and integrity of its staff through its recruitment and retention policies and practices which includes employee vetting. The HKMA further seeks to ensure ongoing training and training sponsorship to enhance staff's financial knowledge and supervisory and management skills (e.g., Basel 3, AML issues, communication and leadership skills). The active participation of senior staff in relevant international fora and maintenance of close interactions with other supervisors and the industry supports the process of keeping abreast with industry and regulatory developments.</p> <p>All HKMA staff are also subject to secrecy obligations under the BO and OSO. Failing to adhere to the secrecy obligations is an offence and the person committing the offence is liable to a fine and imprisonment. Staff are required to sign confidentiality undertakings upon employment and there is an internal Code of Conduct covering issues like integrity, conflict of interest, use of proprietary information and investment guidelines coupled with potential disciplinary action in case of non-adherence. Staff members are provided with copies of the secrecy provisions contained in BO section 120 and OSO Parts III and IV, and are required to sign in acknowledgement of their receipt and confirm understanding of their obligations under the respective provisions. Staff are reminded of the importance of, and their personal obligation in, safeguarding all documents and information covered by the Ordinances and that it is an offence under the Ordinances if the information is disclosed without lawful authority.</p> <p>Furthermore there are policies and procedures on post-termination employment of HKMA staff to guard against conflict of interest.</p> <p>Information protocols within the HKMA ensure that access to information on individual AIs is on a need-to-know basis (this does not extend to restricting staff from being able to interrogate supervisory data for purposes such as making peer group comparisons).</p> <p>In addition to the above, the MA and Deputy Chief Executives of the HKMA, as members of the EFAC and/or its Sub-Committees, are subject to the Code of Conduct applicable to members of EFAC and its Sub-Committees.</p> <p>The HKMA enjoys a high degree of credibility with the industry. All firms with whom the assessors met commented positively on the professionalism and skill set of the HKMA and its focus on financial stability. Many commented favorably on the HKMA staff and approach in comparison with other jurisdictions.</p>
<b>EC6</b>	<p>The supervisor has adequate resources for the conduct of effective supervision and oversight. It is financed in a manner that does not undermine its autonomy or operational independence. This includes:</p> <p>(a) a budget that provides for staff in sufficient numbers and with skills</p>

	<p>commensurate with the risk profile and systemic importance of the banks and banking groups supervised;</p> <p>(b) salary scales that allow it to attract and retain qualified staff;</p> <p>(c) the ability to commission external experts with the necessary professional skills and independence, and subject to necessary confidentiality restrictions to conduct supervisory tasks;</p> <p>(d) a budget and program for the regular training of staff;</p> <p>(e) a technology budget sufficient to equip its staff with the tools needed to supervise the banking industry and assess individual banks and banking groups; and</p> <p>(f) a travel budget that allows appropriate on-site work, effective cross-border cooperation and participation in domestic and international meetings of significant relevance (e.g., supervisory colleges).</p>
<p>Description and findings re EC6</p>	<p>(a) and (b)</p> <p>The HKMA is funded from the Exchange Fund pursuant to the EFO but also by the annual license fees paid by AIs. The use of the Exchange Fund for the purposes specified in the EFO (which include the MA's functions under the BO) is not subject to the approval of LegCo as the Basic Law Article 113 specifically provides that the Exchange Fund shall be controlled by the HKSAR Government. Whilst the Exchange Fund is a government fund, it is a discrete fund established for the purposes set out in the EFO and is managed separately from the general revenue. Hence, the HKMA's budget does not rely on any annual appropriation from the general revenue but is agreed by the EFAC.</p> <p>Under the EFO, staffing expenditure is charged to the Exchange Fund provided that the number of staff appointments and the emoluments of such staff have been approved by the FS. The MA may employ staff on terms different from those of the civil service in order to attract personnel of the right experience and expertise.</p> <p>The pay and conditions of service for the HKMA staff are determined by the FS on the advice of the Governance Sub-Committee through EFAC taking into account the prevailing market rates and practices. The authorities indicated that they considered the remuneration policies to be appropriate for the needs of the HKMA though noted that in areas of skills shortage within the sector (for example, anti-money laundering and combating the financing of terrorism, AML/CFT) recruitment remained a challenge. The remuneration and pay review, and training and development as well as overall annual budget is publicly disclosed in the HKMA Annual Report.</p> <p>The HKMA draws up its annual budget to identify and seek to ensure that sufficient resources are available for the carrying out of its functions effectively. Budgeting seeks to take into account continuing operations and strategic developments set out in the HKMA's three-year plan. The budget draws on the annual Risk Assessment Report drawn up by all HKMA business units. The objective of these reports is to facilitate line management in identifying and measuring the key business functions, risks and controls (including staff resources) of each business unit and to facilitate effective and efficient allocation of resources within the HKMA.</p>



	<p>In discussion the authorities indicated that subject to a clear discipline of demonstrating need, including the lack of reasonable alternative options such as re-allocation of existing resources or streamlining of existing activities, the HKMA was able to access the level of resources it needed to carry out its duties effectively.</p> <p>(c) The HKMA has been able to date to secure adequate funding support to hire outside experts or consultants on contract terms to undertake special projects. Such projects have focused on such issues as risk-based supervision, deposit insurance and resolution. The development of a new unit on resolution has depended on the ability to recruit appropriate external professionals.</p> <p>(d) The HKMA focuses on developing staff capabilities to meet operational demands, career development and new challenges. During 2012 HKMA staff were provided with 3,010 training days, including 1,360 of horizontal training in general skills and 1,650 days of vertical training on job-specific issues. This equates to an average of 3.9 training days for each member of staff.</p> <p>(e) Recognizing the increasing need for data to be collected as a result of the recent Financial Crisis and the increasing need for banking supervision staff, the HKMA is in the process of strengthening its IT support on banking supervision. It has recently revamped the Enhanced Prudential Supervision System (EPSS), which is a system for maintaining individual AI data (e.g., returns, director appointment records, etc.). As a result, the internal Management Information Systems will also be enhanced to improve the effectiveness of banking supervision.</p> <p>(f) The HKMA annual budget addresses travel needs to support HKMA participation in supervisory colleges, crisis management colleges, FSB working groups as well as necessary overseas examinations of AIs in the context of consolidated supervision. The HKMA participates in 29 banking supervisory colleges and nine G-SIB CMGs. In 2012, the HKMA participated in 29 supervisory college meetings, 14 CMG meetings as well as 2 FSB Cross-Border Crisis Management Working Group meetings and 15 overseas on-site examinations.</p>
<b>EC7</b>	As part of their annual resource planning exercise, supervisors regularly take stock of existing skills and projected requirements over the short- and medium-term, taking into account relevant emerging supervisory practices. Supervisors review and implement measures to bridge any gaps in numbers and/or skill-sets identified.
Description and findings re EC7	The HKMA annual budget takes into account both the continuing operations and the strategic developments set out in a three-year plan approved by the FS on the advice of the EFAC. Each department takes stock of existing and projected staff levels and other operational and administrative requirements in the coming year. This includes a consideration of the likely impact of the development or enhancement of regulatory policies and supervisory practices. The Executive Directors of all departments within the HKMA are invited to review existing areas of work which can be streamlined/ downsized and identify new initiatives or enhancement of existing work which may have resource implications.

	<p>When stock taking and planning identifies gaps in resources measures that may be taken include the hiring of external consultants, as with the project on developing resolution capacity, internal redeployment or a request for additional budgeting support. When necessary the HKMA will request additional budgeting support to enhance supervisory intensity. A recent example has been anti-money laundering and counter-terrorist financing (AML) where internal redeployment efforts and provision of additional budgets have enabled a substantial increase of staff headcount in the AML unit in 2013 in response to supervisory concerns.</p> <p>In addition to the annual budgetary process, all HKMA business units are required annually to submit a Risk Assessment Report. The objective of this exercise is to facilitate line management in identifying and measuring the key business functions, risks and controls (including staff resources) of each business unit and to facilitate effective and efficient allocation of resources within the HKMA. The HKMA discloses the actual and budgeted administrative expenditures in its Annual Report.</p>
<b>EC8</b>	<p>In determining supervisory programs and allocating resources, supervisors take into account the risk profile and systemic importance of individual banks and banking groups, and the different mitigation approaches available.</p>
Description and findings re EC8	<p>The HKMA adopted a risk-based approach to supervising AIs in 1999. Details of the supervisory framework are set out in the SPM module SA-1 "Risk-based Supervisory Approach" issued in 2001. The approach, which emphasizes effective planning and supervisory judgment, customizes examinations and supervisory programs to suit the size and activities of AIs and to concentrate supervisory resources on areas that expose the AI concerned to the greatest degree of risk.</p> <p>In practice, in determining supervisory programs, the HKMA seeks to take into account the risk profiles and systemic importance of AIs. The intensity of supervision will be determined in line with an AI's risk profile and more resources are allocated for the supervision of systemically important AIs and for AIs which have been identified as posing greater supervisory concerns. More regular on-site or thematic examinations are conducted in respect of these AIs. The frequency of meetings and engagement with AIs' management at different levels will also be higher in the case of these AIs to discuss supervisory issues that have come to the HKMA's attention through its off-site surveillance of their submitted statistical return data and internal Management Information Systems and reports, issues identified in on-site examinations, complaints, tip-offs, press reports etc.</p> <p><i>Supervisory programs</i></p> <p>The HKMA gathers information from AIs for assessing the risk level of their business activities and the adequacy of their risk management. Based on the risk assessment for an AI, a supervisory plan will be developed for the AI and the scope for on-site examinations will be determined to focus on areas of greatest risk.</p> <p>The plan and scope of examinations is revised from time to time to reflect changes in an AI's risk profile or significant developments in the financial market.</p> <p><i>Resource allocation</i></p> <p>The HKMA undertakes periodic reviews of its internal structure and resources. Some</p>

	<p>recent examples of changes in practices and resource allocations to focus on areas of perceived greater risks include:</p> <ul style="list-style-type: none"> <li>• Major restructuring of the banking departments in 2010 following the global financial crisis. Two new banking departments (i.e. Banking Conduct Department and Enforcement Department) were established, to enhance consumer protection and step up the supervision of securities, investment products, insurance and MPF related businesses of AIs.</li> <li>• Increase of resources to the IRB specialist team.</li> <li>• Greater resources – in terms of number, seniority and experience - allocated to the division responsible for systemically important financial institutions (SIFIs).</li> <li>• Initiation of project to devise a D-SIB framework in HKSAR (industry consultation planned in Q4 2013). This project includes a review of resource allocation in the light of increased supervisory intensity for D-SIBs.</li> <li>• Enhanced surveillance and supervisory scrutiny of AIs' Non-bank Mainland China exposures (NBMCE) in the light of the considerable expansion of Mainland-related credit exposures. The HKMA has asked AIs to report additional, and more granular, data on NBMCE to enable the HKMA to better monitor developments. A new statutory banking return on NBMCE was rolled out in September 2013. (Please see CP21). The HKMA has also increased the examinations of local banks' Mainland operations.</li> </ul>
<b>EC9</b>	Laws provide protection to the supervisor and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith. The supervisor and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.
Description and findings re EC9	<p>Pursuant to BO section 127(1), no liability shall be incurred by the MA and his staff as a result of anything done or omitted to be done by him or his staff bona fide in the exercise or purported exercise of any functions under the BO.</p> <p>There is no specific legal provision that provides that the MA or HKMA staff members will be indemnified in respect of legal costs if they are required to defend claims made against them arising from the discharge of their duties in good faith. However, in line with the Civil Service Regulations of the HKSAR Government, the MA will provide legal representation for his staff members for claims made against them with respect to actions or omissions made in the course of conducting their duties provided they acted in good faith.</p> <p>Although BO section 127(1) has in the past been pleaded in the course of legal actions, ultimately the actions did not proceed to trial and there are no court judgments based on this section.</p>
<b>Assessment of Principle 2</b>	<b>Largely Compliant</b>
<b>Comments</b>	<p>The HKMA enjoys clear de facto but not de jure operational independence. There is no question that in practice the HKMA has autonomy in relation to its day-to-day operations and in the methods it uses to pursue its public policy objectives.</p> <p>As noted above, the HKMA does not enjoy de jure independence. Under the BO</p>

	<p>(Section 10), following the Basic Law, the Chief Executive of HKSAR may direct the MA and overturn his decisions. There is a reserve power in the BO (section 10) for the Chief Executive of HKSAR to give directions to the MA with respect to the exercise of the MA's functions under the BO. This reflects the HKSAR Government's responsibility for formulation of monetary and financial policies and for supervision of financial markets as enshrined in the Basic Law. Whilst no instance of the use of the power could be cited, the possibility of future use cannot be completely ruled out.</p> <p>Further there is no statutory provision that specifies the minimum term of office of the MA, the circumstances under which the MA can be removed from office, or requiring the public disclosure (ex post) of the reasons for dismissal of the MA.</p> <p>In practical terms the authorities indicate that section 10 can be regarded as emergency powers for the Chief Executive of HKSAR. Checks and balances in the use of such powers exist as the Chief Executive's decision would be subject to judicial review, and would need to be in conformity with the purpose and objective of the BO itself. Given that the Chief Executive's actions would not benefit from the same degree of resources, skills, or information as the MA, it is likely that any decision by the Chief Executive of HKSAR to give directions where the effect would be to overturn the MA under BO section 10 would be considered unsafe and, therefore, highly vulnerable to being reversed on challenge.</p> <p>Transparency is an important dimension to consider in the context of independence issues. In relation to transparency surrounding the potential to dismiss the MA, the letter of appointment by the FS includes the confirmation that it is not the FS' intention to terminate the office 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; or bankruptcy. As a matter of good practice there is public disclosure of all staff changes at senior level. Also with respect to transparency, it is noted that the banking chapter in the MA's annual report is required by the BO (section 9(1)) and its publication is at the discretion of the FS and thus not mandatory, although the FS has adopted a transparent approach and it is important that this good practice continues.</p> <p>The exchange of letters in 2003 between the MA and FS did not clarify the circumstances in which the Chief Executive of HKSAR might intervene in the decisions or activities of the MA, even though the responsibilities of the MA were set out in high level terms.</p> <p>Taken as a whole, there is much very good practice and certain important safeguards are in place, such as the potential for judicial review of decisions taken by government authorities. Nonetheless, the independence of the HKMA is not as fully protected by law as it could be and it is recommended that further steps are taken to ensure this. It is therefore recommended that amendments to the BO, or other legislation as appropriate, are made to:</p> <ul style="list-style-type: none"> <li>• Eliminate, the legal authority of the Chief Executive of HKSAR to give directions to the MA, or specify the circumstances where the authority applies, without</li> </ul>
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	<p>impinging on the Basic Law</p> <ul style="list-style-type: none"> <li>• Provide for the public disclosure of the reasons for the dismissal of the MA.</li> </ul> <p>In advance of changes to the law, the authorities could consider whether to undertake a further exchange of letters to clarify the circumstances under which the Chief Executive of HKSAR would act. A public commitment, ahead of legislative change, could also be made to disclose the reason for the dismissal of the MA as relevant.</p>
<b>Principle 3</b>	Cooperation and collaboration. Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors. These arrangements reflect the need to protect confidential information. <sup>10</sup>
<b>Essential criteria</b>	
<b>EC1</b>	Arrangements, formal or informal, are in place for cooperation, including analysis and sharing of information, and undertaking collaborative work, with all domestic authorities with responsibility for the safety and soundness of banks, other financial institutions and/or the stability of the financial system. There is evidence that these arrangements work in practice, where necessary.
<b>Description and findings re EC1</b>	<p>One of the functions of the MA set out in BO section 7(2)(e) is to cooperate with and assist the recognized financial services supervisory authorities of Hong Kong. The BO gives the MA the authority to disclose information to relevant local authorities to assist them in the exercise of their functions. These other authorities include the SFC, IA, MPFA, FRC and DPB. In addition, in the BO and the SFO, there are provisions that set out how the SFC and HKMA should work together in respect of AIs that are engaged in securities business.</p> <p>The HKMA has entered into MoUs with the SFC, IA, MPFA, DPB and FRC to set out the agreed framework for supervisory cooperation and information sharing with each of these bodies. These MoUs establish, among other things, the expectations that the authorities will share with each other information, to the extent permitted by law that will assist in the exercise of their statutory functions.</p> <p>In addition, the FS chairs a CFR, which is an official forum for facilitating cooperation and coordination among local financial regulators and discussing regulatory and supervisory issues that may have cross-sector implications. The members of the Council include the HKMA, SFC, IA and MPFA. The CFR holds meetings on a quarterly basis.</p> <p>There is also FSC chaired by the SFST, of which the HKMA, SFC, and IA are members. The Committee holds meetings on a monthly basis and is responsible for monitoring regularly the functioning of the financial system of Hong Kong and, where appropriate, formulating and coordinating responses to events, issues or developments with possible cross-market and systemic implications.</p> <p>In practice, the HKMA holds regular MoU meetings with the SFC, IA and MPFA to</p>

<sup>10</sup> Principle 3 is developed further in the Principles dealing with “Consolidated supervision” (12), “Home-host relationships” (13) and “Abuse of financial services” (29).

	<p>discuss matters of mutual regulatory and supervisory interest. For example, the HKMA and SFC meet regularly to share information of common interest and discuss enforcement-related matters concerning AIs and their staff engaging in securities-related activities. The HKMA also has day-to-day contact with the domestic financial regulators at the working level to discuss issues, share information of common regulatory interest, exchange views to ensure consistency in interpretation of regulatory standards and undertake collaborative work. Each regulator will use reasonable efforts (e.g., through regular MoU meetings and ongoing contacts at the working level) to ensure that the other party is provided with relevant information of mutual regulatory interest for the exercise of its statutory and supervisory functions.</p> <p>The HKMA and the SFC are also jointly developing the regulatory regime for the local OTC derivatives market with responsibility for enforcing the regime on their respective institutions (e.g., AIs and approved money brokers for the HKMA). The new regime will help monitor the build-up of systemic risk in the local OTC derivatives market.</p> <p>Currently the HKMA, SFC and IA are working together with the FSTB of the HKSAR Government in developing a cross-sectoral resolution regime to reflect the standards in the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes). Cross-sectoral working and steering groups have been formed, reporting regularly to the CFR.</p> <p>In addition, regular market contingency exercises are conducted by the HKSAR Government, local financial regulators and HKEx<sup>11</sup> with a view to testing and ensuring that all parties are able to tackle market contingencies and enhancing their communication and co-operation in handling various emergency scenarios.</p>
<b>EC2</b>	<p>Arrangements, formal or informal, are in place for cooperation, including analysis and sharing of information, and undertaking collaborative work, with relevant foreign supervisors of banks and banking groups. There is evidence that these arrangements work in practice, where necessary.</p>
<b>Description and findings re EC2</b>	<p>The function of the MA set out in BO section 7(2)(e) also includes cooperating with and assisting overseas financial sector supervisory authorities. BO section 121 allows the MA to disclose information to overseas supervisory authorities on the conditions that:</p> <ul style="list-style-type: none"> <li>• the authority concerned is subject to adequate secrecy provisions; and</li> <li>• the disclosure is: <ul style="list-style-type: none"> <li>○ desirable or expedient in the interests of depositors or potential depositors or the public interest; or</li> <li>○ to assist the authority to exercise its functions and is not contrary to the interests of depositors or potential depositors or the public interest.</li> </ul> </li> </ul> <p>The HKMA has entered into MoUs with 26 banking regulators in 22 jurisdictions and maintains a close working relationship with them. At the time of the assessment, the</p>

<sup>11</sup> HKEx is the operator and frontline regulator of the central securities and derivatives marketplace in Hong Kong.

	<p>HKMA was negotiating with a number of additional overseas banking supervisory authorities with a view to entering into MoUs for supervisory cooperation and sharing of information. Within the structure of the MoUs, efforts are made to ensure the timely sharing of bank-specific prudential information with relevant overseas supervisors and information on other issues of common interest.</p> <p>Even in the absence of signed MoUs, the HKMA can and does share prudential information with overseas authorities to the extent permitted by local laws and regulations.</p> <p>The HKMA, as the home supervisor, participated in bilateral meetings with overseas banking regulators from 14 jurisdictions and carried out 15 overseas on-site examinations in 2012. It is a practice of the HKMA to send a copy of on-site examination reports of AIs to their respective home or host supervisors.</p> <p>The HKMA is a member of 29 supervisory colleges organized by foreign home regulators as many large, internationally active banks maintain a presence in HKSAR. These supervisory colleges provide a venue for collaborative analysis and work and information sharing by participating supervisors. For local AIs with overseas operations (except for a few which have significant overseas operations and which have already been included in the colleges organized by foreign home regulators), the HKMA noted that it finds it more effective to deal with cross-border supervisory matters with the overseas host regulators on a bilateral basis because the overseas operations of these AIs are neither extensive nor significant.</p> <p>The assessors noted that the HKMA has given particular attention over the past several years to strengthening its relationship with the China Banking Regulatory Commission (CBRC) in recognition of the close ties between the two banking systems. In discussions with the assessors, the HKMA officials mentioned that they also periodically discuss with the People's Bank of China macroeconomic developments on the Mainland.</p>
<b>EC3</b>	<p>The supervisor may provide confidential information to another domestic authority or foreign supervisor but must take reasonable steps to determine that any confidential information so released will be used only for bank-specific or system-wide supervisory purposes and will be treated as confidential by the receiving party.</p>
<b>Description and findings re EC3</b>	<p>As mentioned above, the BO allows the MA to disclose confidential information to certain domestic or overseas supervisory authorities. In the case of disclosure to domestic authorities, the MA must be satisfied that disclosure is desirable or expedient in the interests of depositors or potential depositors or the public interest or that such disclosure will enable or assist the recipient to exercise its functions. In the case of disclosure to overseas supervisory authorities, the MA should satisfy itself that the recipient authorities are subject to adequate secrecy provisions in their own countries and that disclosure is desirable or expedient in the interest of depositors or potential depositors or the public interest or that such disclosure will enable or assist the recipient to exercise its functions.</p> <p>The domestic regulators with which the MA exchanges information are also subject to</p>

	<p>secrecy provisions under their respective legal frameworks. The MoUs with domestic regulators contain provisions that safeguard the confidentiality and proper use of any information exchanged between the regulators and the HKMA. Similar provisions in respect of confidentiality and proper use of information are also contained in the MoUs signed with overseas regulators.</p> <p>Regulators receiving the information, regardless of whether they have signed an MoU, are required to restrict access to information solely to officials engaged in regulatory or supervisory functions and not to release information to other parties without the HKMA's prior consent. With regard to overseas regulators, if the regulator concerned is in a jurisdiction in respect of which the HKMA is unfamiliar with the banking secrecy and data privacy requirements, the HKMA will check whether there are adequate secrecy provisions applicable to the regulator before disclosing any information to it.</p>
<b>EC4</b>	<p>The supervisor receiving confidential information from other supervisors uses the confidential information for bank-specific or system-wide supervisory purposes only. The supervisor does not disclose confidential information received to third parties without the permission of the supervisor providing the information and is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession. In the event that the supervisor is legally compelled to disclose confidential information it has received from another supervisor, the supervisor promptly notifies the originating supervisor, indicating what information it is compelled to release and the circumstances surrounding the release. Where consent to passing on confidential information is not given, the supervisor uses all reasonable means to resist such a demand or protect the confidentiality of the information.</p>
<b>Description and findings re EC4</b>	<p>Under BO section 120(1), HKMA staff and external experts appointed by the MA are required to preserve secrecy with regard to all supervisory information that may come to their knowledge in the exercise of any function under the BO, including confidential information provided by domestic or overseas supervisory authorities. Contravention of such requirements is an offence and the person committing the offence is liable to a fine and imprisonment.</p> <p>There are a number of specific statutory gateways in the BO for disclosure for various purposes and to various bodies that have statutory responsibilities for regulation of the financial sectors, investigation of criminal matters, etc. The BO imposes no duty on the MA to use these gateways. The MA would, however, do so should these authorities obtain an appropriate court order. The assessors confirmed that, to date, this has never occurred.</p> <p>To safeguard confidential information received from other supervisory authorities, the HKMA requires in its internal Code of Conduct that its staff should provide adequate safeguards to prevent abuse or misuse of proprietary information.</p> <p>As regards confidential information received in supervisory colleges, the HKMA is also bound by confidentiality agreements contained in MoUs with home supervisors and/or college-specific confidentiality agreements.</p>
<b>EC5</b>	<p>Processes are in place for the supervisor to support resolution authorities (e.g., central</p>



	banks and finance ministries as appropriate) to undertake RRP and actions.
<b>Description and findings re EC5</b>	<p>The MA is the authority responsible for undertaking RRP and executing resolution actions regarding AIs incorporated in HKSAR or in support of overseas resolution authorities with respect to AIs incorporated outside of HKSAR, subject to the conditions and limits provided in the BO.</p> <p>Among the functions of the MA set out in the BO is that of cooperating with and assisting recognized financial services supervisory authorities of Hong Kong or any place outside Hong Kong, whenever appropriate, to the extent permitted by the BO.</p> <p>The HKMA is in the process of establishing a local framework for RRP for AIs in Hong Kong that is designed to meet the standards outlined in the FSB's Key Attributes. In late 2012 the HKMA started a consultation with the industry on RRP requirements for AIs, which closed in January 2013. After considering the responses, the HKMA is refining its proposals with a view to issuing new SPM modules on Recovery Planning and Resolution Planning. The HKMA is also working with the SFC, IA and the FSTB of the HKSAR Government to establish a cross-sectoral resolution regime in line with the FSB's Key Attributes.</p> <p>The BO allows the MA to disclose information to overseas supervisory authorities that exercise functions corresponding to the functions of the MA on the conditions mentioned in EC 2 above. These provisions (subject to the specified conditions) can be used to facilitate cooperation in the context of RRP and actions on the basis that the MA has resolution functions under the BO (and hence the overseas resolution authorities' functions correspond to those of the MA). There is, however, no specific provision covering cooperation in actual resolution procedures.</p> <p>The HKMA works within relevant CMGs for international banks on formulating recovery and resolution plans in accordance with the timetable set by the FSB. In discussions with the assessors, the HKMA noted that the CMGs are an effective channel for information exchange and cooperation and coordination between the home and host authorities of G-SIBs to develop firm-specific group-level recovery and resolution plans.</p>
<b>Assessment of Principle 3</b>	Compliant
<b>Comments</b>	<p>The assessors determined that the HKMA has strong working relationships with other domestic financial sector supervisory authorities, with an ongoing exchange of information and discussions regarding issues of mutual interest and concern. These relationships are conducted at both the most senior levels of management and on a more informal, day-to-day working level.</p> <p>The HKMA also demonstrated that they have good working relationships with other relevant foreign supervisory authorities, both those with which they have a formal MoU and those with which they continue to deal on a more informal basis. The HKMA also participates in supervisory colleges for foreign banks that have a significant presence in Hong Kong.</p>

	To date, there have not been any instances where the confidentiality of information provided by the HKMA to other supervisory authorities or received from such authorities has been violated.
<b>Principle 4</b>	Permissible activities. The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined and the use of the word “bank” in names is controlled.
<b>Essential criteria</b>	
<b>EC1</b>	The term “bank” is clearly defined in laws or regulations.
<b>Description and findings re EC1</b>	<p>As defined in BO section 2(1), the term “bank” means “a company which holds a valid banking license” and “banking license” means “a banking license granted under section 16.” Hong Kong maintains a three-tier system of AIs: banks, RLB, and DTC. The three terms are defined in the BO and any person seeking to carry on business as a bank, RLB or DTC is required to be authorized by the MA.</p> <p>Only institutions authorized by the MA (i.e. AIs) can conduct banking or deposit-taking business.</p>
<b>EC2</b>	The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.
<b>Description and findings re EC2</b>	<p><i>Banking activities</i></p> <p>The banking or deposit-taking activities permissible for each of the three types of AIs are as follows:</p> <p>Bank: “banking business”, which is defined under BO section 2(1) as “the business of either or both of the following:</p> <ul style="list-style-type: none"> <li>• receiving from the general public money on current, deposit, savings or other similar account payable on demand or within less than three months or with a call period or notice of less than three months;</li> <li>• paying or collecting checks drawn by or paid in by customers.”</li> </ul> <p>RLB: the business of taking call, notice or time deposits of HK\$500,000 and above of any maturity (BO section 14 and Schedule 1).</p> <p>DTC: the business of taking deposits of HK\$100,000 or above with an original term to maturity, or call or notice period, of at least three months (BO section 14 and Schedule 1).</p> <p>The term “deposit” is defined under BO section 2(1). The BO also specifies categories of non-authorized persons under section 3 who are not subject to the restrictions on the taking of deposits (e.g., trust companies registered under the Trustee Ordinance).</p> <p>The business of lending and of property/securities investment is restrained by statutory limitations. BO sections 80-85 define prohibitions/limits on lending. BO sections 87 and 87A define limits on the holding of share capital of other companies by AIs: 5 percent of the AI’s capital base for each holding in an individual company, 25</p>

	<p>percent in aggregate for such holdings. Finally, BO section 88 limits an AI's holdings of interest in land to 25 percent of its capital base.</p> <p>Otherwise, there is no restriction in general on the range of lending or investment activities AIs can enter into so long as these are not expressly prohibited by laws and regulations, meet supervisory expectations (e.g., adequate risk management systems and expertise for specific activities) and do not generally affect the interests of depositors or adversely affect the safety and soundness of the AIs.</p> <p><i>Non-banking financial activities</i> Subject to valid registration required under the relevant regime, AIs are allowed to conduct the following non-banking financial activities where the HKMA is their frontline supervisor:</p> <p><i>Securities business</i> Under the SFO, AIs are required to register with the SFC in order to conduct regulated activities under the SFO. The AIs that are registered to carry on regulated activities are subject to the rules, codes and guidelines issued by the SFC under the SFO, as well as additional benchmarks prescribed by the HKMA in relation to regulated activities.</p> <p><i>MPF intermediary activities</i> AIs are required to register with the MPFA in order to carry on a regulated activity under the MPFSO. The AIs that are registered to carry on regulated activities are subject to the codes, guidelines, rules, regulations and circulars issued by the MPFA under the MPFSO, as well as additional benchmarks prescribed by the HKMA in relation to MPF intermediary activities.</p> <p><i>Insurance intermediary activities</i> Insurance intermediaries are subject to a self-regulatory regime as set out in the ICO Part X. AIs are required to register with the relevant SROs to sell insurance products. AIs selling insurance products are required to comply with the applicable codes and guidelines issued by the IA and the SROs, as well as additional benchmarks prescribed by the HKMA in relation to insurance intermediary activities.</p> <p><i>Other non-banking activities</i> There is no restriction in general on the range of other non-banking activities AIs can enter into so long as these are not expressly prohibited by laws and regulations, meet supervisory expectations (e.g., adequate risk management systems and expertise for specific activities) and do not generally affect the interests of depositors or adversely affect the safety and soundness of the AIs.</p> <p>In practice, the Banking Supervision Department (BSD) ensures that AIs adhere to the restrictions under BO sections 11, 12, 14 and 79-91, where applicable, through its ongoing supervision by reviewing information submitted by AIs in the relevant statistical returns and through on-site examinations.</p> <p>For business activities not covered by specific supervisory guidance, the MA exercises supervision on AIs by applying the broad principles of prudence and legality to assess</p>
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	<p>the risk posed to an AI by any business it conducts. The MA is concerned with the entire business of an AI, rather than only the banking or deposit-taking business.</p> <p>Under the risk-based approach, the HKMA would identify the major non-banking and non-financial activities through reviewing the structure of the bank group and its associated entities including subsidiaries. The BSD monitors closely all major business activities of AIs, including the scale and propriety of any non-banking activities.</p> <p>The assessors noted that while a rather broad range of permissible activities exist in Hong Kong, the activities of individual AIs receive close scrutiny by the HKMA as part of their ongoing supervisory oversight of the AIs. The activities of each institution are reviewed on an individual basis to ensure that these activities do not pose an unacceptable risk to the AI.</p>
<b>EC3</b>	<p>The use of the word "bank" and any derivations such as "banking" in a name, including domain names, is limited to licensed and supervised institutions in all circumstances where the general public might otherwise be misled.</p>
<b>Description and findings re EC3</b>	<p>Under BO section 97(1), it is an offence for any person, other than a bank authorized under the BO or a central bank of the place in which it is incorporated, without the written consent of the MA, to:</p> <ul style="list-style-type: none"> <li>• use the word "bank" or any of its derivatives in English, or any translation thereof in any other language, in the description or name under which such person is carrying on business in Hong Kong; or</li> <li>• make any representation in any bill head, letter paper, notice, advertisement or in any other manner that such person is a bank or is carrying on banking business in Hong Kong.</li> </ul> <p>BO section 97 also contains a number of exemptions from the general restriction. Certain exemptions are also available to local representative offices approved under BO section 46 and to RLBs whereby they may use the word "bank" in a certain prescribed manner in carrying on business in Hong Kong under BO section 97(1A) and section 97(3) respectively.</p> <p>A company that is a subsidiary, holding company, or a subsidiary of the holding company of a bank may use the name of that bank in the name or description under which it is carrying on business in Hong Kong as regulated by the General Consent granted by the MA.</p> <p>The HKMA has issued further guidance on the MA's policy on the granting of specific consents for the use of banking names or descriptions by companies (or other persons) that are not banks. The guidance sets out the MA's criteria for granting consent, the conditions for consent and the application procedures. In general, the MA will consider giving consent only if the use of the word "bank" does not have the potential for causing confusion to the general public and to blur the distinction between "bank" and "non-bank."</p> <p>The HKMA receives enquiries from the public / media from time to time in relation to institutions that use the word "bank" to describe themselves in conducting business in</p>

	<p>Hong Kong. Where a potential contravention of BO section 97 is detected, the HKMA will, after assessing the seriousness of the situation and the potential public and supervisory concerns it raises, normally undertake one or more of the following actions:</p> <ul style="list-style-type: none"> <li>• refer the case to the Department of Justice of the HKSAR Government with a recommendation whether or not to prosecute the institution;</li> <li>• request the institution to rectify the position (by ceasing to use the word “bank”) as soon as possible;</li> <li>• request the institution to abstain from the use of the word “bank” and apply to the MA for consent under BO section 97.</li> </ul> <p>If the HKMA is aware of any suspected fraudulent website which looks similar to the website of any existing AIs or uses the word “bank” as the name of the institution without the MA’s consent, the HKMA will publish a press release to alert members of the public in Hong Kong and refer the case to the Hong Kong Police Force for investigation. The HKMA will also request the institution concerned (i.e. the proprietor of the suspected fraudulent website) to rectify the issue as soon as possible.</p>
<b>EC4</b>	<p>The taking of deposits from the public is reserved for institutions that are licensed and subject to supervision as banks.<sup>12</sup></p>
<b>Description and findings re EC4</b>	<p>The business of taking deposits from the public is restricted by the BO to AIs that are authorized and supervised by the HKMA (except for cases exempted under section 3). The term “deposit” is defined under BO section 2(1). Contravention constitutes an offence under the BO punishable by fines and imprisonment.</p> <p>BO section 12(1) prohibits the business of taking deposits in Hong Kong except by an AI. Where the prohibition does not apply because the business of taking deposits is being carried on outside Hong Kong, the deposit-taker will still have to observe the disclosure requirements under BO Schedule 5 in advertising for deposits in Hong Kong. BO Schedule 5 specifies the requirements applicable to prescribed advertisements. Every prescribed advertisement shall contain a prominent warning to the effect that the deposit-taker is not an AI within the meaning of the BO and is therefore not subject to the supervision of the MA.</p> <p>The HKMA receives enquiries from the public / media from time to time in relation to suspected cases of illegal deposit-taking such as through a fraudulent internet website or through advertisement. In such cases the HKMA will investigate the matter (in conjunction with the Police if necessary), alert the general public through announcement by press release and consider recommending prosecution to the Department of Justice if warranted.</p>
<b>EC5</b>	<p>The supervisor or licensing authority publishes or otherwise makes available a current list of licensed banks, including branches of foreign banks, operating within its</p>

<sup>12</sup> The Committee recognizes the presence in some countries of non-banking financial institutions that take deposits but may be regulated differently from banks. These institutions should be subject to a form of regulation commensurate to the type and size of their business and, collectively, should not hold a significant proportion of deposits in the financial system.

	jurisdiction in a way that is easily accessible to the public.
<b>Description and findings re EC5</b>	<p>Under BO section 20, the MA is required to maintain a register, accessible to the public that contains the information of every AI and every foreign bank that has a Local Representative Office (LRO) in Hong Kong. Such information includes the name of these institutions, the address of their principal place of business in Hong Kong and such other particulars as are required by the MA.</p> <p>In practice, an electronic register of AIs and LROs in Hong Kong is kept at the HKMA Information Centre for public inspection. The HKMA also updates the register and publishes the information in the Gazette and newspapers as required under the BO. In addition, a full list of AIs and LROs is available on the HKMA's public website. The list is updated on a bi-weekly basis.</p>
<b>Assessment of Principle 4</b>	Compliant
<b>Comments</b>	<p>The BO clearly defines the term bank and prohibits the use of the term and any derivations for institutions that are not licensed and supervised as banks (with some exemptions being permitted at the discretion of the MA). The taking of deposits from the public is clearly reserved for licensed AIs that are subject to ongoing supervision by the HKMA.</p> <p>The permissible activities of banks are defined quite broadly; however, the MA has the clear authority to judge the prudence and legality of the activities conducted by individual institutions.</p>
<b>Principle 5</b>	Licensing criteria. The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of Board members and senior management) <sup>13</sup> of the bank and its wider group, and its strategic and operating plan, internal controls, risk management and projected financial condition (including capital base). Where the proposed owner or parent organization is a foreign bank, the prior consent of its home supervisor is obtained.
<b>Essential criteria</b>	
<b>EC1</b>	The law identifies the authority responsible for granting and withdrawing a banking license. The licensing authority could be the banking supervisor or another competent authority. If the licensing authority and the supervisor are not the same, the supervisor has the right to have its views on each application considered, and its concerns addressed. In addition, the licensing authority provides the supervisor with any information that may be material to the supervision of the licensed bank. The

<sup>13</sup> This document refers to a governance structure composed of a board and senior management. The Committee recognizes that there are significant differences in the legislative and regulatory frameworks across countries regarding these functions. Some countries use a two-tier board structure, where the supervisory function of the board is performed by a separate entity known as a supervisory board, which has no executive functions. Other countries, in contrast, use a one-tier board structure in which the board has a broader role. Owing to these differences, this document does not advocate a specific board structure. Consequently, in this document, the terms "board" and "senior management" are only used as a way to refer to the oversight function and the management function in general and should be interpreted throughout the document in accordance with the applicable law within each jurisdiction.

	supervisor imposes prudential conditions or limitations on the newly licensed bank, where appropriate.
<b>Description and findings re EC1</b>	<p>The HKMA is both the licensing authority and the banking supervisor of AIs in Hong Kong (see BO sections 7 and 15).</p> <p>BO section 15 requires a company that proposes to carry on banking business or the business of taking deposits as a deposit-taking company or restricted license bank to apply to the MA for authorization.</p> <p>Under the BO, the MA has the power to:</p> <ul style="list-style-type: none"> <li>• authorize, or refuse to authorize, an institution to carry on banking business or the business of taking deposits in Hong Kong (section 16(1));</li> <li>• impose conditions on such authorization if necessary (section 16(5)); and</li> <li>• revoke or suspend its authorization after consultation with the FS (sections 22(1), 24(1) and 25(1)).</li> </ul> <p>The Licensing team, which is a specialized team in the Banking Conduct Department, is responsible for handling applications for authorization and procedures for revocation.</p>
<b>EC2</b>	Laws or regulations give the licensing authority the power to set criteria for licensing banks. If the criteria are not fulfilled or if the information provided is inadequate, the licensing authority has the power to reject an application. If the licensing authority or supervisor determines that the license was based on false information, the license can be revoked.
<b>Description and findings re EC2</b>	<p>Under BO section 16(1), the MA may grant or refuse authorization to a company.<sup>14</sup> Without limiting the power of the MA to refuse authorization under BO section 16(1)(b) for any other reason he may deem adequate, the minimum authorization criteria are set out in BO Schedule 7. Under BO section 16, all such criteria must be met for the MA to grant authorization to a company.</p> <p>The MA's interpretation of the authorization criteria is set out in the Guideline on Minimum Criteria for Authorization (Authorization Guideline). They are also set out, together with the MA's interpretation of the grounds for revocation and the procedures for processing applications for authorization, in the "Guide to Authorization" (GTA) which is available on the HKMA public website. The MA executes the powers of authorization and revocation in accordance with the relevant provisions of the BO. The documents required to be submitted with the formal application are set out in the GTA Annex 2. The MA may require additional information from the applicants as is necessary for him to reach a decision on the application.</p> <p>The MA has the power under BO Schedule 8 Paragraph 6 to revoke authorization of an AI if it provides information that is, to a material extent, false, misleading or inaccurate.</p> <p>Under BO section 135, the Chief Executive in Council may, by notice in the Hong Kong</p>

<sup>14</sup> In this assessment, "company" in BO Schedule 7 is defined in BO section 2(1) i.e. as the institution to be authorized. The term "applicant" (as used in the GTA) is used only where there is no ambiguity as to the meaning.

	<p>Government Gazette, amend BO Schedule 7. Whenever there is a need to revise the authorization criteria, the MA will seek the approval of the Chief Executive in Council to amend BO Schedule 7 (the amendment, as subsidiary legislation, will be subject to negative vetting by the Legislative Council).</p> <p>Under BO section 16(1), the MA has a general discretion to grant or refuse an application for authorization. Moreover, BO section 16(2) requires that the MA shall refuse to authorize a company if it cannot meet any one or more of the criteria specified in BO Schedule 7.</p> <p><i>Use of powers to set licensing criteria</i></p> <p>Licensing criteria have been updated at the initiative of the MA with some frequency, either through the legislative process or through the Chief Executive in Council. BO Schedule 7 has been amended in the years 2001, 2002, 2005 and 2012.</p> <p><i>Vetting of licensing applications</i></p> <p>Apart from the statutory requirements, there are other procedural and documentation requirements set out in the GTA. The specific documentation that the MA may require to support the application includes, for example, a report on the CAR, which is certified by the external auditors. At present, all applications for authorization are processed by the Licensing team. There are internal procedures and checklists for staff to refer to when handling applications for authorizations.</p> <p>All applications for authorization are assessed internally before they are recommended to the MA for approval. All key authorization criteria are listed in a checklist. The Licensing team assesses whether the applicant can satisfy each criterion by filling out the checklist before making any recommendation to the BSRC (see Principle 2 EC 4 for details of the BSRC).</p> <p>No recommendation to approve an application will be made if any one of the criteria is not fulfilled or the information provided is inadequate to prove compliance with the criteria by the applicant. Any applicant that is considered as unable to meet one or more of the authorization criteria, either at the preliminary stage of assessment or at the BSRC meeting, will be informed. The application will be rejected if the applicant is unable to take remedial actions to address the MA's concerns.</p> <p><i>Revocation of license in case of false information</i></p> <p>To ensure as far as possible that the information provided is correct, the Licensing team normally requires such information to come from the top management of the applicant. Important supporting documents (e.g., M&amp;A, financial statements) are usually required to be certified. In case of personal questionnaires (e.g., standard forms to be filled in and submitted to accompany an application to become chief executive, alternate chief executive, director or controller), a declaration that the information provided is complete and accurate is included. In any case, if the information provided by the applicant is false to a material extent, this would likely be a ground for revocation pursuant to BO Schedule 8 (6) and the license could be revoked accordingly.</p>
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<b>EC3</b>	The criteria for issuing licenses are consistent with those applied in ongoing supervision.
<b>Description and findings re EC3</b>	<p>The minimum authorization criteria specified in BO Schedule 7 Paragraphs 4 through 12 cover, inter alia, (i) fitness and propriety of management and controllers; (ii) compliance with regulatory requirements in respect of capital adequacy, liquidity and asset quality; (iii) adequacy of internal controls and financial disclosure; and (iv) whether the business is carried on with integrity, prudence and competence. These criteria are all explicitly defined as applicable on an ongoing basis also after authorization.</p> <p>As stated in the Authorization Guideline and in GTA Chapter 4, the criteria in BO Schedule 7 are continuing in nature. That is, they apply to institutions not only at the time of authorization but also thereafter. They form the basis for the HKMA's ongoing supervision of AIs and are consistent with the prudential standards and requirements imposed on them.</p> <p>The Banking Supervision Department (BSD) is responsible for ensuring that AIs continue to meet the minimum authorization criteria after authorization is granted. Through the ongoing supervisory process (such as on-site examination, off-site review and prudential meeting and tripartite meeting with external auditors), AIs are required to comply with a number of prudential standards (e.g., minimum CAR, loan classification requirements, minimum liquidity ratio) that are essential for ensuring their compliance with the authorization criteria.</p> <p>In case an AI falls short of meeting any specific authorization criterion, the BSD will require the AI to undertake prompt remedial actions and/or consider whether there is a need for further supervisory actions to be taken to protect the interests of depositors.</p>
<b>EC4</b>	The licensing authority determines that the proposed legal, managerial, operational and ownership structures of the bank and its wider group will not hinder effective supervision on both a solo and a consolidated basis. <sup>15</sup> The licensing authority also determines, where appropriate, that these structures will not hinder effective implementation of corrective measures in the future.
<b>Description and findings re EC4</b>	<p>BO Schedule 7 enables the MA to ensure this through:</p> <ul style="list-style-type: none"> <li>• knowing the identity of each controller of the company (Paragraph 3);</li> <li>• satisfying himself that the directors, controllers as well as the chief executive or executive officers of the company are fit and proper and, in the case of a foreign company, that the chief executive or executive officer of the business in Hong Kong and the chief executive, directors and controller of the business in the place where the company is incorporated, are also fit and proper (Paragraphs 4 and 5); and</li> <li>• satisfying himself that the company has adequate accounting systems and adequate systems of control (Paragraph 10).</li> </ul>

<sup>15</sup> Therefore, shell banks shall not be licensed. (Reference document: BCBS paper on shell banks, January 2003.)

	<p>The MA supervises locally incorporated institutions on a consolidated basis in respect of capital adequacy, concentration of exposures and liquidity. The main objective of consolidated supervision is to enable the MA to assess any weaknesses existing within a banking/financial group that may impact the AI itself, and if possible, to initiate defensive or remedial action.</p> <p>In conducting consolidated supervision, the MA requires the controllers of AIs to be fit and proper on a continuing basis (BO Schedule 7 (4)). To discharge this responsibility, the HKMA will not only be interested in the holding company, but also the operations of the sister companies of an AI within the group, to the extent that they could have a material impact on the AI. The review by which the HKMA assesses the fitness and propriety of controllers takes account of the effect of the holding companies and the operations of any sister companies on AIs. This power helps inform the consolidated supervision of the AI by the HKMA. Moreover, under BO section 70(2)(b), the approval of an AI's controllers may be subject to conditions, including with regard to reporting requirements after approval.</p> <p>To assess the suitability of a holding company as a majority shareholder controller<sup>16</sup> of an AI, the HKMA will take into consideration such factors as the following (see SPM CS-1 Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions, section 6.3):</p> <ul style="list-style-type: none"> <li>• the group's legal, managerial and operational structures;</li> <li>• the quality of group corporate governance and management oversight;</li> <li>• the group's risk profile, with special attention to intra-group transactions and susceptibility to contagion; and</li> <li>• risk management and internal controls.</li> </ul> <p>(See also EC 5.)</p> <p>Although the MA does not have a direct legal power under the BO to supervise holding companies of AIs that are not themselves AIs, under BO section 63(2A), the MA may require the holding company of the AI, any subsidiary of any such holding company and any subsidiary of an AI to submit such information as the MA may reasonably require for the exercise of his functions under the BO. In the case where the request for information is made to the holding company or a subsidiary of the holding company, the MA must be satisfied that such information is necessary in the interests of depositors or potential depositors of the institution.</p> <p>SPM CG-1 "Corporate Governance of Locally Incorporated AIs" sets out the expected standards that will be applied by the MA on locally incorporated AIs, in particular, SPM CG-1 section 2.7 requires that the organizational complexity of an AI does not prevent</p>
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<sup>16</sup> Defined in BO section 2 as, in relation to a company, any person who, either alone or with an associate or associates, is entitled to exercise, or controls the exercise of, more than 50% of the voting power at any general meeting of the company or of another company of which it is a subsidiary.

	<p>effective control of the AI's activity in its entirety and the AI should avoid setting up unnecessarily complicated structures and recognize the risks that the complexity of the structure itself may pose.</p> <p>Applicants are required to submit their list of controllers and ownership structure at group level, as well as the organization chart, staffing plan, authorities to be delegated to the chief executive and his management team for their proposed entity in Hong Kong for consideration. They also have to submit a business plan including information on accounting systems and internal controls to be implemented in the proposed Hong Kong operation to the HKMA for review. Based on the information provided, the Licensing team will evaluate whether the accounting systems and internal controls are commensurate with the nature and scale of the business of the company to ensure that the business will be run in a prudent and efficient manner, and proper records are maintained and accurate supervisory information will be provided to the HKMA.</p> <p>If an applicant plans to outsource any banking-related business area (including back office activities), the applicant will be required to complete a questionnaire to assess whether the proposed outsourcing arrangements will be able to fulfill all the requirements set out in SPM SA-2 "Outsourcing." The applicant should ensure, among other things, that the proposed arrangements may not result in the internal control systems or business conduct being compromised or weakened after the activity has been outsourced, and that the outsourcing will not impede the access to data by the HKMA, particularly in the case of outsourcing to overseas jurisdictions. The applicant is also required to ensure that the outsourcing agreement with the service provider contains a clause that allows for supervisory inspection or review of the operations and controls of the service provider as they relate to the outsourced activity. For outsourcing to overseas jurisdictions, the Licensing team may also communicate directly with the applicant's home or host regulators, where necessary, to seek their comments on the proposed outsourcing arrangements.</p> <p>The Licensing team will seek comments from the relevant local and overseas authorities concerning the fitness and propriety of the controllers, directors and the designated chief executive / alternate chief executive(s). In case either the applicant or any of its controllers is supervised by an overseas regulator, comments of the regulator will also be sought as to the manner in which the banking group is supervised as a whole and the Licensing team takes into account whether the regulator exercises consolidated supervision in deciding whether the legal structure will in any way hamper consolidated supervision.</p> <p>In order to satisfy the authorization criterion under BO Schedule 7 Paragraph 2(b), the overseas-incorporated company must be adequately supervised by the relevant supervisory authority. Therefore, application for authorization from a shell bank will not be accepted by the HKMA.</p> <p>It is the MA's general policy that a person who holds more than 50 percent of the share capital of an AI incorporated in Hong Kong (hereafter referred to as "local AI") should be a well established bank or other supervised financial institution in good</p>
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	<p>standing in the financial community and with appropriate experience. In considering applications from persons who do not fulfill this requirement, the MA's primary concern will be to ensure that any risks that may be posed to the existing or proposed AI by the applicant, and any other members of the corporate group of which the applicant is a member, are understood and well contained. To achieve this, the MA may impose conditions on the applicant.</p> <p>In many cases local AIs are subsidiaries of international banking groups, and hence the ultimate consolidated supervision of the relevant financial group vests with the home banking regulators.</p> <p>There are only a few cases in Hong Kong where no holding company of a local bank is either supervised by the MA or an overseas banking regulator. For these few cases, the local banks generally form a dominant part of the groups to which they belong.</p> <p>In Q3 2013, the HKMA implemented an enhanced framework for the consolidated supervision of banking groups to obtain an adequate degree of oversight over the holding companies of locally incorporated licensed banks (thereafter referred to as "local banks") based on the MA's power to attach conditions to the consent given for them to be / become majority shareholder controllers of local banks under BO section 70. This framework is applicable to cases where no holding company of a local bank is a regulated entity. (See Principle 12, EC 2.)</p>
<b>EC5</b>	<p>The licensing authority identifies and determines the suitability of the bank's major shareholders, including the ultimate beneficial owners, and others that may exert significant influence. It also assesses the transparency of the ownership structure, the sources of initial capital and the ability of shareholders to provide additional financial support, where needed.</p>
<b>Description and findings re EC5</b>	<p>BO Schedule 7 provides that the MA has to be satisfied not only about the identity of the controllers of the company but also that each of them is fit and proper (Paragraphs 3, 4 and 5). Under BO section 2, "controller" includes an "indirect controller", which is defined as "in relation to a company, means any person in accordance with whose directions or instructions the directors of the company or of another company of which it is a subsidiary are accustomed to act, but does not include a Manager or Advisor, or any person in accordance with whose directions or instructions those directors are accustomed to act by reason only that they act on advice given by him in his professional capacity."</p> <p><i>Identification of controllers</i></p> <p>In applying the authorization criteria, the MA must be satisfied that he knows the identity of each controller of the company. The applicant is required to provide detailed information about the company's ownership structure and each of its shareholder controllers by submitting to the HKMA a questionnaire for controller (for overseas applicants) or an application form to become a controller (for local applicants). The questionnaire and application form request the shareholder controller to provide detailed information about, among other things, its voting power and beneficial interest in the company.</p>

	<p><i>Suitability of controllers</i></p> <p>The MA must also satisfy himself that controllers of the institution are fit and proper under BO Schedule 7. In applying the fit and proper test, the MA will take into consideration the financial background and reputation of the controllers, in particular, their capacity to undertake the proposed business plan of the company. It is generally the MA's practice that a person who intends to hold 50 percent or more of the share capital of an AI incorporated in Hong Kong should be a well-established bank or other supervised financial institution in good standing in the financial community and with appropriate experience.</p> <p>When approving the foreign controllers of locally incorporated AIs under BO section 70, the MA will rely heavily on the views of the home supervisor, but also reserves the right to take into account any other information that may be available to him. The Licensing team will review the background information on proposed controllers and seek confirmation as to their suitability where applicable from other regulators as part of the authorization process.</p> <p>Those applying to become controllers of a locally incorporated AI are required to submit a standard form with relevant background information on the applicant's (i) past experience; (ii) business history; (iii) involvement in litigation, disciplinary proceedings or sanctions etc. based on which the Licensing team will carry out the fit and proper assessment.</p> <p>Under BO Schedule 7 Paragraph 6, the MA has to be satisfied that the company has and will, if it is authorized, continue to have adequate financial resources for the nature and scale of its operations in Hong Kong. AIs are required under Paragraph 6(a)-(c) of the Schedule to maintain minimum absolute levels of share capital (including paid-up share capital and balance of share premium account).</p> <p>As set out in the Authorization Guideline and in the GTA Chapter 4, the MA will take account of the ability (i.e. financial resources) and willingness of shareholders to provide additional financial support to the institutions, in the form of capital and/or liquidity injections in case of need.</p> <p><i>Initial capital</i></p> <p>Regarding the company's initial capital, the Licensing team will ensure at the time of authorization that it is adequate to meet the authorization requirements under BO Schedule 7 Paragraph 6 by reference to the audited financial statements submitted by the applicant and if necessary (e.g., in case of foreign applicant not supervised by a member jurisdiction of the Basel Committee), an auditor's certificate on the level of CAR calculated in accordance with the Basel capital framework.</p> <p><i>Ability of controllers to provide additional financial support</i></p> <p>The applicant is required to provide financial information on each of the company's shareholder controllers to the HKMA for assessment. The Licensing team, where necessary, will also make reference to research reports issued by credit rating agencies to facilitate the assessment of the shareholder controllers' financial position. If the company is incorporated in Hong Kong, it is the practice of the Licensing team to</p>
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	request all the company's minority and majority shareholder controllers to provide a letter of comfort whereby they commit to provide capital and/or liquidity support to the institution in case of need.
<b>EC6</b>	A minimum initial capital amount is stipulated for all banks.
<b>Description and findings re EC6</b>	<p>Under BO Schedule 7 (6), a company, whether incorporated locally or overseas, is required to have, and continue to have if authorized, the following minimum aggregate amount of paid-up share capital and balance of share premium:</p> <p style="margin-left: 40px;">Bank :       HK\$300Mn  RLB :        HK\$100Mn  DTC :        HK\$25Mn</p> <p>Compliance with the minimum initial capital requirement in BO Schedule 7 Paragraph 6 is reviewed as part of the authorization process. Institutions applying for authorization are normally required to provide information about its shareholder's equity for the past 3 years.</p> <p>If the company is authorized, it will be monitored on an on-going basis under the risk-based supervisory process including through regular off-site surveillance. Failure to meet the minimum capital requirement by existing AIs constitutes one of the grounds for revocation of authorization under BO Schedule 8 Paragraph 2.</p>
<b>EC7</b>	The licensing authority, at authorization, evaluates the bank's proposed Board members and senior management as to expertise and integrity (fit and proper test), and any potential for conflicts of interest. The fit and proper criteria include: (i) skills and experience in relevant financial operations commensurate with the intended activities of the bank; and (ii) no record of criminal activities or adverse regulatory judgments that make a person unfit to uphold important positions in a bank. <sup>17</sup> The licensing authority determines whether the bank's Board has collective sound knowledge of the material activities the bank intends to pursue, and the associated risks.
<b>Description and findings re EC7</b>	<p>BO Schedule 7, (4) and (5) provide that among other things the MA must be satisfied that each person who is, or is to be, a chief executive or director of the company is a fit and proper person to hold the particular position which he holds or is to hold.</p> <p>The MA also has a statutory responsibility under BO section 71 to consider whether or not to consent or object to the appointment of:</p> <ul style="list-style-type: none"> <li>• the directors and chief executive of an AI incorporated in Hong Kong; and</li> <li>• the chief executive of the Hong Kong business / operation of an AI incorporated outside Hong Kong.</li> <li>• the term "chief executive" includes an alternate chief executive.</li> </ul>

<sup>17</sup> Please refer to Essential Criterion 8.

	<p>The fitness and propriety of proposed directors and chief executive / alternate chief executive(s) are assessed based on the criteria set out in the Authorization Guideline and in the GTA Chapter 4. These include:</p> <ul style="list-style-type: none"> <li>• probity, reputation and character (including whether the applicant has any criminal or adverse regulatory record);</li> <li>• knowledge, experience and competence;</li> <li>• financial soundness and independence.</li> </ul> <p>Moreover, pursuant to BO sections 73(1) and (1A), no person shall, without the consent from the MA, become or continue to be an employee of an AI if that person: (i) is or becomes bankrupt; (ii) has been or is convicted of an offence involving fraud or dishonesty; or (iii) knows, or ought reasonably to know, that, in respect of an AI of which he is or was a director, chief executive or manager, the AI is being, or has been, wound up or otherwise dissolved, or its license or registration has been revoked.</p> <p>Under BO Schedule 7 Paragraph 5A, the MA must be satisfied that an institution seeking authorization has, and will if it is authorized continue to have, adequate systems of control to ensure that each person who is, or is to be, a manager of the institution is a fit and proper person to hold the particular position which he holds or is to hold. When assessing the fitness and propriety of managers, AIs should have regard to a number of considerations including probity, reputation and character; knowledge, experience and competence; and financial soundness and independence (SPM CG-2 Paragraph 3.1.1). SPM CG-2 Paragraph 3.2.1 further specifies that, among the factors an AI should consider, should be whether the individual has been convicted of any criminal offence, or has a record of non-compliance with various non-statutory codes.</p> <p>As part of the evaluation process on possible conflicts of interest and to ensure independence of independent non-executive directors, such directors should not be involved in the management of the bank and should be free from any business or other relationship that could materially interfere with the exercise of their independent judgment in relation to the affairs of the bank. This requirement is stipulated in the Authorization Guideline and in the GTA Chapter 4.</p> <p>The Licensing team handles the vetting procedures of these applications in accordance with established internal procedures. In considering whether a proposed director, chief executive or alternate chief executive is fit and proper, the Licensing team will have regard to information provided by the applicant and comments from relevant local and foreign supervisory authorities as part of the required vetting procedures. The detailed procedures for processing such applications are set out in the operation procedures for application for chief executive, alternate chief executive or director under BO section 71.</p> <p>Any person applying to become a director (for locally incorporated AIs), chief executive or alternate chief executive is required to submit a standard form to the HKMA for assessment. Among other things, the applicants are required to provide information on their relationship with the AIs for the purpose of ascertaining whether there are any issues on conflicts of interest.</p>
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	<p>To enable the MA to consider whether a proposed candidate for appointment to a locally incorporated AI's Board or as its chief executive, alternative chief executive is fit and proper to carry out his or her duties, the MA may, where he considers it appropriate, conduct a face-to-face meeting with the candidate. The face-to-face meeting is one of the new initiatives introduced by the HKMA in recent years to enhance the corporate governance of AIs. This allows the MA to assess first-hand the candidate's personal qualities, skills, knowledge and understanding of the AI's business and key regulatory and supervisory requirements (such as requirements relating to risk management practices, capital adequacy and liquidity) and whether he will be able to fulfill adequately the role for which he is being considered.</p> <p>The team assesses whether the HKMA needs to conduct a face-to-face meeting with the applicant as part of the assessment process. Meetings will be conducted selectively based on a number of factors, including the HKMA's assessment of the AI's systemic importance to the Hong Kong banking sector, the background and experience of the candidate and whether the candidate is already well known to the HKMA. The meetings can help the HKMA to form a more detailed view of a candidate's experience and qualities and fitness and propriety for the role applied for, and afford the HKMA an opportunity to get to know future directors, chief executives and alternate chief executives, and to make clear the HKMA's expectations with regard to their roles. The meetings are expected to support, but do not replace, the existing vetting process.</p> <p>The Licensing team ensures that the company for authorization has a competent Board to oversee the proposed operations. For locally incorporated AIs, their Board should comply with SPM CG-1 which sets out the HKMA's requirements on, among other things, responsibilities, composition, organization and functioning of the Board. Regardless of whether a company is incorporated locally or overseas, each member of the Board will be subject to the standard review procedures by the Licensing team to ascertain their fitness and propriety. The relevant experience and background of each director will be reviewed to ensure that they are capable of overseeing the company's proposed activities.</p> <p>Applicants for authorization are required to provide information on the systems of control for the appointment of managers having regard to the requirements set out in the Authorization Guideline and in the GTA Chapter 4. After the institutions are authorized, the Banking Supervision Department will request AIs to submit relevant policies and procedures for its review and, if necessary, check the adequacy of the systems in place during on-site examinations (SPM CG-2 Chapter 5).</p>
<b>EC8</b>	<p>The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance, risk management and internal controls, including those related to the detection and prevention of criminal activities, as well as the oversight of proposed outsourced</p>



	functions, will be in place. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank. <sup>18</sup>
<b>Description and findings re EC8</b>	<p><i>Provisions under the BO</i></p> <p>Under BO section 16(2), the MA is expressly required to assess whether the company fulfills the criteria specified in BO Schedule 7 which relate, inter alia, to:</p> <p><i>Strategic and operating plans of company</i></p> <p>The business of the company is presently, and will if it is authorized continue to be, carried on with integrity, prudence and appropriate degree of professional competence (Paragraph 12).</p> <p><i>Corporate governance</i></p> <p>The directors, controllers, chief executives and executive officers of the company are fit and proper persons. The company should also have adequate systems of control for the appointment of managers (Paragraphs 4, 5 and 5A).</p> <p><i>Internal controls</i></p> <p>The company should have and, if authorized, continue to have adequate accounting systems and systems of control (Paragraph 10).</p> <p>The MA's expectations of the general objectives and major components of risk management internal control systems are set out in the statutory guidelines and other relevant guidelines issued / updated by the MA from time to time; these include:</p> <ul style="list-style-type: none"> <li>• SPM CG-1 Corporate Governance of Locally Incorporated AIs</li> <li>• SPM CG-2 Systems of Control for the Appointment of Managers</li> <li>• SPM IC-1 General Risk Management Controls</li> <li>• Guideline on Anti-Money Laundering and Counter-Terrorist Financing</li> <li>• SPM CG-3 Code of Conduct</li> <li>• SPM SA-2 Outsourcing</li> </ul> <p>As set out in the Authorization Guideline and in the GTA Chapter 4, in assessing the internal control systems and procedures of an institution, the MA will have regard to its size, nature and complexity of operation, the volume of transactions undertaken, its structure and organization, and the geographical distribution of the business.</p> <p>GTA Chapter 8 sets out the application procedures for applying for authorization under BO section 16. Under Paragraph 8.6, applicants are required to submit a business plan for the first three years of the proposed operation in Hong Kong. The business plan should describe the nature and scale of business to be undertaken and business strategies to be adopted, as well as details of the proposed management, organizational structure and control systems. It should also include financial projections on the first three years of the operation, including the projected balance sheet, capital adequacy (where applicable) and liquidity ratios and profitability. Comments from the home supervisor will also be sought in the case of a foreign</p>

<sup>18</sup> Please refer to Principle 29.

	<p>applicant (Paragraph 8.15).</p> <p>The Licensing team takes the above information into account in assessing whether the company has a prudent business plan and adequate corporate governance to support such plan.</p> <p>The applicant also has to submit information on the risk management and internal control systems to be implemented in the proposed Hong Kong operation to the HKMA for review. The systems should include liquidity management policy, anti-money laundering guideline, controls related to outsourcing activities, risk limits, large exposure limits, structure of management committees and their relevant authorities. The adequacy of internal controls is a major consideration in the authorization process. Applicants are required to describe how the proposed Hong Kong operations can satisfy the requirements set out in the SPM modules.</p>
<b>EC9</b>	<p>The licensing authority reviews pro forma financial statements and projections of the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank.</p>
<b>Description and findings re EC9</b>	<p>BO Schedule 7 Paragraph 6 provides that the MA must be satisfied that the company presently has, and will if authorized continue to have, financial resources (whether actual or contingent) adequate for the nature and scale of its business.</p> <p>BO Schedule 7 Paragraph 7 provides that the MA must be satisfied that the company presently maintains, and will if it is authorized continue to maintain, adequate liquidity to meet the obligations as they will or may fall due. Paragraph 12 further requires the company to carry on its business with integrity, prudence and an appropriate degree of professional competence and in a manner not detrimental or likely to be detrimental to the interests of depositors or potential depositors.</p> <p>As set out in the Authorization Guideline and in the GTA Chapter 4, the HKMA will take into account the financial capacity and willingness of shareholders to provide additional financial support to the company as part of its assessment on the fitness and propriety of the shareholder controllers.</p> <p>GTA Annex 2 sets out the documents required to be submitted on application for authorization. It states that the company should, among others, submit its annual report for the last three years immediately prior to application and the financial projections for the first three years of the proposed Hong Kong operation, including projected balance sheet, liquidity ratio and profitability. The HKMA will take into account these supporting documents when assessing the financial strength of the applicants to support the proposed strategic plan.</p> <p>The applicant is required to submit its annual reports (and those of its principal shareholders) for the last three years and the financial projections of its Hong Kong operation for the first three years to the Licensing team. This is to evaluate the financial strength of the company and its controllers and ensure that they have sufficient financial resources to support the business plan in Hong Kong. In making the</p>

	<p>assessment, the Licensing team will also have regard to capital adequacy, liquidity and other financial indicators. These assessment factors are included in the internal checklist and the Licensing team will make comments on each of these factors. The Licensing team will also ensure that the business plan is realistic and reasonable.</p> <p>In the case of foreign applicants, comments from overseas regulators will be sought whenever appropriate.</p>
<b>EC10</b>	<p>In the case of foreign banks establishing a branch or subsidiary, before issuing a license, the host supervisor establishes that no objection (or a statement of no objection) from the home supervisor has been received. For cross-border banking operations in its country, the host supervisor determines whether the home supervisor practices global consolidated supervision.</p>
<b>Description and findings re EC10</b>	<p>GTA Chapter 8 states that overseas applicants will generally require the approval of their home regulators for establishing a presence in Hong Kong. Where the applicant is a bank incorporated outside Hong Kong, the MA will confirm with the relevant banking supervisory authority that it has given the consent for the applicant to establish a branch or subsidiary in Hong Kong.</p> <p>In practice, the Licensing team will request an overseas incorporated applicant to submit a copy of the official approval (or letter of consent) of its home supervisor for the establishment of the operation in Hong Kong as one of the standard documents required to be submitted for assessment. The Licensing team will also write to the home supervisor to (i) confirm directly with the home supervisor that the latter has no objection to the applicant's proposal to establish a presence in Hong Kong and exercises consolidated supervision on the applicant, including the proposed entity in Hong Kong and (ii) its views on other relevant matters in respect of the applicant (e.g., its right to conduct general banking business, the manner in which the applicant and its group companies are being supervised, adequacy of its internal controls, financial soundness such as the adequacy on capital, liquidity and asset quality, and fitness and probity of its controllers and management).</p> <p>BO Schedule 7, Paragraph 2 requires that if a company seeking authorization is incorporated outside Hong Kong, it must be a bank as defined in BO section 46(9) and in respect of which the MA is satisfied that it is adequately supervised by the relevant banking supervisory authority.</p> <p>The Authorization Guideline and GTA Chapter 4 explain in greater detail what is meant by adequacy of home supervision. Among other things, the home supervisory authority should be capable of performing consolidated supervision. In considering the adequacy of supervision, the MA (as the host supervisor of the local operation of a foreign bank) will have regard to the extent to which the home supervisor has established, or is actively working to establish, the necessary capabilities to meet the Basel Committee's standards relating to the supervision of international banks. In particular, the MA will take account of:</p> <ul style="list-style-type: none"> <li>• the legal and administrative powers of the home supervisor;</li> <li>• the supervisory framework of the home supervisor, including the scope of its</li> </ul>

	<ul style="list-style-type: none"> <li>• consolidated supervision;</li> <li>• the method of supervision adopted by, and the resources available to, the home supervisor; and</li> <li>• past experience in dealings with the home supervisor.</li> </ul> <p>As indicated in the Authorization Guideline and in the GTA Chapter 4, the minimum authorization criteria under the BO Schedule 7, including the adequacy of home supervision, are continuing in nature, which means they apply to institutions not only at the time of authorization but also thereafter. Failure to meet the criteria by existing AIs would be a ground for revocation of authorization under BO Schedule 8.</p> <p>The HKMA maintains regular contacts with overseas supervisors. The contacts start from the authorization process, during which the MA will seek assurances from the relevant banking supervisory authority about the management and financial standing of the applicant, and also information about the scope of that supervisor's consolidated supervision. Before recommending the authorization of a foreign AI, the Licensing team will, among other things, conduct an assessment of the adequacy of home supervision based on the criteria set out in the GTA. These include the ability of the home supervisor to conduct consolidated global supervision.</p>
<b>EC11</b>	<p>The licensing authority or supervisor has policies and processes to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the license approval are being met.</p>
<b>Description and findings re EC11</b>	<p>Most of the authorization criteria included under BO Schedule 7 are continuing in nature. These include BO Schedule 7 Paragraph 12 which provides that the MA must be satisfied that the business of the institution is presently, and will if authorized continue to be, carried on with integrity, prudence and the appropriate degree of professional competence and in a manner which is not detrimental or likely to be detrimental to the interests of depositors or potential depositors.</p> <p>To ensure that this is the case, and that other authorization criteria are satisfied at all times, the MA will, inter alia:</p> <ul style="list-style-type: none"> <li>• conduct regular examination and investigation on AIs under BO section 55;</li> <li>• require AIs to submit prudential returns under BO section 63(2);</li> <li>• require AIs to submit reports by external auditors certifying the correct compilation of certain banking returns (e.g., CAR, liquidity) and internal control systems under BO section 63(3) and(3A) on a yearly basis;</li> <li>• require AIs to submit reports on specific areas of systems of control under BO section 59(2), where necessary.</li> </ul> <p>After being authorized, an AI is expected to submit to the BSD information about the current year business performance and the business plan for the following year and to discuss the information with the BSD in the annual off-site review and prudential meeting. Any significant deviation from the previous targets will be discussed and accounted for. The AI will also be subject to on-going off-site surveillance (particularly through the review of banking returns submitted) and regular on-site examinations to</p>

	<p>ensure that the relevant authorization criteria are met on a continuing basis. The supervisory process for AIs is outlined in the SPM SA-1 Risk-based Supervisory Approach.</p> <p>During the annual off-site review, the BSD will review the AI's latest progress of implementation of its business and strategic goals for the assessment of the level and trend of the AI's strategic risk. Internal Guidance Note No. 2/2000 "Risk Based Supervisory Approach" section 3.15 sets out the criteria for evaluation of inherent strategic risk.</p>
<b>Assessment of Principle 5</b>	Compliant.
<b>Comments</b>	<p>The HKMA has established a framework of rigorous policies and procedures to carefully review applications for entry into the domestic banking system, whether by a domestic or foreign entity. The criteria for licensing new AIs are set in law and clearly articulated in HKMA guidelines. These criteria also form a key component of the ongoing supervisory process of the HKMA; thereby ensuring that they continue to be met after the AI commences operation. It is therefore helpful that most of the Licensing Team's current 18 staff have a supervision background.</p> <p>The HKMA has the legal authority to revoke the license of any AI if it discovers that information provided during the licensing process was materially inaccurate or misleading.</p> <p>For applications by foreign organizations, the HKMA determines that the home supervisory authority does not object to establishment of the operations in Hong Kong and that the home authority is competent and practicing consolidated supervision on an ongoing basis.</p> <p>In reviewing documents related to bank licensing, the assessors were able to verify the thoroughness of the licensing process and noted that use of a checklist by Licensing Team staff ensures that all licensing criteria set out in laws and regulations are addressed.</p> <p>The assessors commend the HKMA for their recent initiative to conduct face-to-face meetings on a selective basis with key individuals as part of the licensing process. This will help to ensure that proposed candidates for Board or senior management positions are fit and proper for their respective positions.</p>
<b>Principle 6</b>	Transfer of significant ownership. The supervisor <sup>19</sup> has the power to review, reject and impose prudential conditions on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
<b>Essential criteria</b>	
<b>EC1</b>	Laws or regulations contain clear definitions of "significant ownership" and "controlling

<sup>19</sup> While the term "supervisor" is used throughout Principle 6, the Committee recognizes that in a few countries these issues might be addressed by a separate licensing authority.

	interest.”
<b>Description and findings re EC1</b>	<p>Significant ownership and controlling interest are defined by the following terms under BO section 2:</p> <p>Majority Shareholder Controller: a person who either alone or with an associate or associates is entitled to exercise, or control the exercise of, over 50 percent of the voting power at a general meeting of a company or of another company of which it is a subsidiary;</p> <p>Minority Shareholder Controller: a person who either alone or with associates is entitled to exercise, or control the exercise of, 10 percent or more (but not more than 50 percent) of the voting power at a general meeting of a company or of another company of which it is a subsidiary;</p> <p>Indirect Controller: a person in accordance with whose directions or instructions the directors of a company or of another company of which it is a subsidiary are accustomed to act but does not include a Manager or Advisor or any person who gives advice in his professional capacity.</p> <p>The above definitions of “majority shareholder controller” and “minority shareholder controller” include also beneficial owners of shares, in so far as the latter are entitled to control the exercise of the voting power of nominee owners of shares.</p> <p>The supervisory policy for establishing whether a person falls within the meaning of a majority shareholder controller, a minority shareholder controller or an indirect controller is set out in the internal circular of 30 July 1996. As a matter of course, the HKMA takes into account the complexity and all relevant facts in each case in determining whether a person falls within the meaning of a controller under the BO.</p>
<b>EC2</b>	There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership, including beneficial ownership, or the exercise of voting rights over a particular threshold or change in controlling interest.
<b>Description and findings re EC2</b>	<p>Changes in ownership of an AI incorporated in Hong Kong over a particular threshold level require the specific approval of the MA under the BO. BO section 70(3) provides that no person shall become a minority shareholder controller, a majority shareholder controller or an indirect controller of an AI unless he has served a notice on the MA to become such a controller, and the MA has granted the relevant consent or has not served a notice of objection within 3 months upon receiving the notice from that person. Beneficial owners who control the exercise of the requisite voting power and therefore fall within the definition of “controller” are also subject to BO sections 70 and 70A.</p> <p>Any person who contravenes BO section 70(3) commits an offence under the BO that is punishable by fines and imprisonment.</p> <p>The responsibility for approving changes of control of an AI incorporated outside Hong Kong rests with its home supervisor. Nevertheless, the AI is expected to notify</p>

	<p>the MA of any significant changes in its ownership. Under BO Schedule 7 Paragraph 3, it is an authorization criterion that the MA should be satisfied that the identity of each controller of an AI (whether incorporated in or outside Hong Kong) is known. This is a continuing authorization requirement. Breach of such criterion by an AI is a ground for revocation of its authorization.</p> <p>Locally incorporated AIs are expected to consult the HKMA in respect of proposed changes in controllers well in advance so that any prudential issues can be addressed at an early stage, and they have generally adopted this in practice.</p> <p>Whenever a person is approved to be a controller of an AI under BO section 70, the MA will ask the AI and the controllers to inform him of any change to the controllers' shareholding in the AI in the MA's approval letters to them. This facilitates the monitoring of changes to an AI's controllers.</p> <p>The HKMA obtains and reviews the updated shareholding structure of all locally and overseas incorporated AIs during regular off-site reviews to ensure that all existing controllers are identified and, in the case of locally incorporated AIs, the controllers have obtained the MA's approval under BO section 70.</p>
<b>EC3</b>	<p>The supervisor has the power to reject any proposal for a change in significant ownership, including beneficial ownership, or controlling interest, or prevent the exercise of voting rights in respect of such investments to ensure that any change in significant ownership meets criteria comparable to those used for licensing banks. If the supervisor determines that the change in significant ownership was based on false information, the supervisor has the power to reject, modify or reverse the change in significant ownership.</p>
<b>Description and findings re EC3</b>	<p>Under BO section 70(3), a person proposing to become a minority shareholder controller, a majority shareholder controller or an indirect controller of an AI incorporated in Hong Kong is required to apply to the MA for prior approval. Beneficial owners who control the exercise of the requisite voting power and therefore fall within the definition of "controller" are also subject to BO sections 70 and 70A.</p> <p>The MA will assess whether a prospective controller is fit and proper based on the assessment criteria set out in the Guideline on Minimum Criteria for Authorization and in Guide to Authorization (GTA) Chapter 4. The application form requires the applicant to provide, among other things, relevant background information on the applicant including experience, financial positions and previous involvement in litigation, disciplinary proceedings or sanctions.</p> <p>If the MA is satisfied that the person is fit and proper to be a controller based on the assessment criteria, the MA may issue a notice of consent. The MA may also issue a conditional notice of consent, specifying the conditions under which there are no objections for the person to become a controller.</p> <p>If the MA is not satisfied that the person is fit and proper to be a controller, he has the authority to issue a notice of objection under BO section 70(6)(b). The MA may also withdraw his consent through serving a notice of objection under BO section 70A in</p>

	<p>respect of an existing controller whom he no longer considers to be fit and proper (this may include, for example, the case where the controller had obtained the MA's consent by deception through the provision of false information), or if the interest of depositors in the AI are in some other manner threatened by that person being such a controller, or if that person has contravened any condition specified in a conditional notice of consent.</p> <p>Where a person is a controller without the MA's consent or the MA has served a notice of objection, the MA may exercise his powers under BO section 70B to, among other things, serve restrictions on the exercise of the voting rights of the shares held by the controller concerned, if warranted.</p> <p>Moreover, under BO Schedule 8, Paragraphs 13 and 14, it is a ground for revocation of authorization of an AI if a person contravenes BO section 70 or 70A by becoming or continuing to be a controller of the AI in spite of the MA's objection to this.</p> <p>In the ongoing supervision of an AI, if the fitness and propriety of an existing controller of the AI is called into question, the concerned case team within BSD of the HKMA will re-assess the suitability of that person to continue to act as controller based on the same set of assessment criteria set out in the Guideline on Minimum Criteria for Authorization and in GTA Chapter 4. If the controller is assessed to be no longer fit and proper, the BSD can propose for the deliberation of the BSRC to recommend the MA to exercise his power under BO section 70A to serve a notice of objection to a person to be a controller of an AI.</p>
<b>EC4</b>	<p>The supervisor obtains from banks, through periodic reporting or on-site examinations, the names and holdings of all significant shareholders or those that exert controlling influence, including the identities of beneficial owners of shares being held by nominees, custodians and through vehicles that might be used to disguise ownership.</p>
<b>Description and findings re EC4</b>	<p>The authorization criterion under BO Schedule 7 Paragraph 3, requiring the MA to be satisfied that he knows the identity of each of the controllers of an AI incorporated in or outside Hong Kong is continuing in nature (see Principle 5 EC 3).</p> <p>The HKMA obtains from AIs the information of all significant shareholders, including the identities of beneficial owners of shares held by nominees, custodians and through vehicles mainly through the following means:</p> <ul style="list-style-type: none"> <li>• during off-site reviews, the BSD obtains updated information on the shareholding structure of AIs. If the shareholding of an AI is held by a vehicle, the BSD can ascertain the identity of beneficial owners of shares held through the vehicle.</li> <li>• in addition, the BSD obtains information on the shareholding structure of AIs from the annual report submitted by AIs. Based on the information obtained, the BSD can request AIs to provide information regarding the beneficial owners of the AIs' shares (e.g., their identities). Where necessary, the MA can make use of his information gathering power under BO section 63(2) to obtain such information. The MA can also exercise powers under BO section 63(2A)</li> </ul>



	<p>requiring the holding company of the AI to provide the relevant information.</p> <p>If necessary, the MA will seek the assistance of the home supervisor of an institution incorporated outside Hong Kong in order to obtain this information.</p>
<b>EC5</b>	<p>The supervisor has the power to take appropriate action to modify, reverse or otherwise address a change of control that has taken place without the necessary notification to or approval from the supervisor.</p>
<b>Description and findings re EC5</b>	<p>For locally incorporated AIs, BO Part XIII specifies the circumstances where approval for a change of control is required from the MA. Under BO section 70(6) and (9), the MA can serve a notice of objection on a person who has become a majority or minority shareholder controller or an indirect controller of an AI incorporated in Hong Kong without obtaining approval from the MA under BO section 70(3). Any person who becomes a controller without the MA's consent or who, after becoming aware of the fact that he has become a controller does not notify the MA of that fact within 14 days commits an offence and is liable to a fine and imprisonment.</p> <p>Under BO Schedule 8 Paragraphs 13 and 14, it is a ground for revocation of authorization of an AI if a person contravenes BO section 70 by becoming or continuing to be a controller of the AI in spite of the MA's objection to this.</p> <p>An AI incorporated outside Hong Kong is not required to obtain the MA's approval for change of control. However, the AI is expected to notify the MA of any significant changes in its ownership or management so as to demonstrate that it complies with the relevant minimum authorization criteria set out in BO Schedule 7.</p> <p>In the regular off-site reviews of AIs, the BSD obtains updated information regarding the shareholding structure from the locally incorporated AIs to check that the relevant controllers have obtained the necessary consent under BO section 70 from the MA. Moreover, whenever a person is approved to be a controller of an AI, the MA will ask the AI and the controllers to inform him of any change to the controllers' shareholding in the AI in the MA's approval letter.</p> <p>If the HKMA is aware of any change of control of an AI without the MA's prior approval, the HKMA will seek explanation for the contravention and obtain all necessary information from the parties and the AI concerned to determine what supervisory actions should be taken.</p> <p>If the MA is satisfied with the fitness and propriety of the person concerned, he may issue a notice of consent to the person to be a controller of the AI to rectify the contravention. Otherwise, the MA may issue a notice of objection to the person. In either case, the HKMA will consider the need to refer the case to the Department of Justice of the HKSAR Government to consider whether prosecution under BO section 70(18) is warranted.</p>
<b>EC6</b>	<p>Laws or regulations or the supervisor require banks to notify the supervisor as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder or a party that has a controlling interest.</p>

<b>Description and findings re EC6</b>	<p>According to SPM CS-1 “Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions” section 6.4, the HKMA will generally expect the controller of an AI to notify the HKMA of any developments as soon as practicable that may affect the controller’s financial position, principal activities or management and hence the suitability as controller of the AIs. The notification requirement can be formally set out as conditions attached to the MA’s approval for becoming a majority shareholder controller under BO section 70.</p> <p>BO Schedule 7 Paragraphs 4 and 5 provide that the MA must be satisfied that each person who is, or is to be, a controller including minority shareholder controller of an AI is a fit and proper person to hold the particular position. The requirement is continuing in nature and therefore applies to the AI not only at the time of authorization but also thereafter. Failure to meet the requirement would be a ground for revocation of authorization. As such, the AI is expected to notify the HKMA as soon as it becomes aware of any material information that may negatively affect the suitability of a major shareholder or a party that has a controlling interest. The HKMA has issued a circular to all AIs making explicit its requirement to be notified under this criterion.</p>
<b>Assessment of Principle 6</b>	Compliant.
<b>Comments</b>	The BO clearly defines “significant ownership” and “controlling interest” and there are clear requirements for supervisory approval and notification in the case of any changes to the ownership structure. The HKMA expects locally incorporated AIs to consult with them regarding proposed changes in controllers in advance so that any prudential concerns can be addressed at an early stage.
<b>Principle 7</b>	Major acquisitions. The supervisor has the power to approve or reject (or recommend to the responsible authority the approval or rejection of), and impose prudential conditions on, major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and to determine that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
<b>Essential criteria</b>	
<b>EC1</b>	<p>Laws or regulations clearly define:</p> <ul style="list-style-type: none"> <li>(a) what types and amounts (absolute and/or in relation to a bank’s capital) of acquisitions and investments need prior supervisory approval; and</li> <li>(b) cases for which notification after the acquisition or investment is sufficient. Such cases are primarily activities closely related to banking and where the investment is small relative to the bank’s capital.</li> </ul>
<b>Description and findings re EC1</b>	<p>AIs incorporated in Hong Kong are subject to the following approval requirements under the BO in respect of their investments in, or acquisitions of, other companies:</p> <p>Section 49 – requires an AI incorporated in Hong Kong to seek the MA’s prior approval for the establishment of an overseas branch or representative office.</p>

	<p>Section 51A(2) – requires an AI incorporated in Hong Kong to seek the MA’s prior approval for the establishment or acquisition of an overseas banking subsidiary.</p> <p>Section 87A(2) – prohibits an AI incorporated in Hong Kong from acquiring all or part of the share capital of a company to a value of 5 percent or more of the AI’s capital base at the time of acquisition without the MA’s prior approval.</p> <p>Section 87 – further limits the shareholdings of an AI incorporated in Hong Kong in other companies to an aggregate of no more than 25 percent of its capital base. Certain shareholdings (e.g., holding of shares in another AI or in a company carrying out financially related functions specified in section 87(2)(b)(ii)) may be exempted from this limitation with the MA’s approval.</p> <p>In view of the above BO provisions, most of an AI’s acquisitions or investments are already subject to prior approval or advance notification requirements. Beyond that, SPM CR-L-5 “Major Acquisitions and Investments: §87A” makes clear the MA’s expectation that AIs will notify the MA in advance of other acquisitions that may have a significant impact on their financial position, business strategy, managerial resources or reputation. These cover the following:</p> <ul style="list-style-type: none"> <li>• those that would cause the AI to become a significant shareholder in another financial institution in Hong Kong or overseas, in particular where such acquisitions require the consent from another regulator;</li> <li>• those that would result in the AI acquiring a subsidiary required to be consolidated under BO Part XV or XVIII and BCR section 3C in relation to loans and interest, liquidity ratio and CAR respectively;</li> <li>• those that would have a material adverse impact on the CAR of the AI (say 0.5 percent or more); and</li> <li>• those that would represent a significant diversification by the AI into a new line of business or into non-financial activities.</li> </ul> <p>The HKMA expects locally incorporated AIs to discuss with it their plans for major acquisitions or investments at an early stage so that any prudential concerns arising from the plans can be addressed beforehand. The HKMA monitors whether locally incorporated AIs have any plan for material acquisitions/investments and ensures their compliance with statutory requirements through its regular supervisory reviews.</p>
<b>EC2</b>	Laws or regulations provide criteria by which to judge individual proposals.
<b>Description and findings re EC2</b>	<p>The relevant criteria for assessment of individual proposals requiring the approval of the MA under BO section 51A or section 87A are set out respectively in two statutory guidelines: CG-4 “Establishment of Overseas Banking Subsidiaries: section 51A” and CR-L-5 “Major Acquisitions and Investments: section 87A.” The criteria include:</p> <ul style="list-style-type: none"> <li>• nature of business of the company to be acquired and its compatibility with that of the AI;</li> <li>• financial capacity of the AI to fund the acquisition and the potential impact on its capital adequacy;</li> <li>• capacity of the AI to manage the acquisition, the group structure and adequacy</li> </ul>

	<p>of internal control after acquisition;</p> <ul style="list-style-type: none"> <li>• any undue risks to which the AI may be exposed arising from the acquisition; and</li> <li>• laws, regulations and the supervisory regime of the place of incorporation of the company to be acquired (particularly whether the relevant laws are consistent with those in Hong Kong and whether there are any secrecy constraints that would inhibit effective consolidated supervision by the MA).</li> </ul> <p>The HKMA will assess a proposal based on the criteria set out in the guidelines. Depending on individual situations, further information may be required (e.g., the manner in which the AI's exposures to the company to be acquired and the company's exposures to other related companies will be controlled). In addition, the HKMA will ensure that, apart from any prudential concerns, the relevant legal issues are fully addressed.</p>
<b>EC3</b>	<p>Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor also determines, where appropriate, that these new acquisitions and investments will not hinder effective implementation of corrective measures in the future.<sup>20</sup> The supervisor can prohibit banks from making major acquisitions/investments (including the establishment of cross-border banking operations) in countries with laws or regulations prohibiting information flows deemed necessary for adequate consolidated supervision. The supervisor takes into consideration the effectiveness of supervision in the host country and its own ability to exercise supervision on a consolidated basis.</p>
<b>Description and findings re EC3</b>	<p>The objective of the MA's approval process is to ensure that the interests of depositors or potential depositors of the AI concerned will not be threatened by the acquisition/investment. BSD case teams review the information submitted by the locally incorporated AI. The factors that will be considered in the review include:</p> <ul style="list-style-type: none"> <li>• nature of business of the company to be acquired;</li> <li>• the impact of the acquisition on the AI's capital adequacy and financial position;</li> <li>• any undue risks to which the AI may be exposed arising from the acquisition / investment;</li> <li>• managerial capacity and risk management of the AI to run the business to be acquired in a prudent and reputable manner;</li> <li>• quality of supervision of the country in which the business to be acquired is located (i.e. the host country), e.g., the extent to which the country complies with international standards; and</li> <li>• ability of the HKMA to exercise consolidated supervision.</li> </ul> <p>Where necessary, a meeting with the locally incorporated AI's management is also held to discuss the proposal and the supervisory concerns of the HKMA, if any.</p>

<sup>20</sup> In the case of major acquisitions, this determination may take into account whether the acquisition or investment creates obstacles to the orderly resolution of the bank.

	<p>In case the HKMA considers that the company to be acquired should be included in its subsequent consolidated supervision of the locally incorporated AI, the HKMA will ascertain whether necessary information in relation to the financial soundness and risk management of the company can be obtained to enable the HKMA to supervise the locally incorporated AI on a consolidated basis through the usual means of on-site examinations, off-site reviews and supervisory cooperation, etc. Where applicable, the HKMA will seek comments from other local or overseas regulators of the company to ascertain the way in which it is supervised as well as its former compliance record.</p> <p>The list of information required by the MA would include (but is not limited to) the following in terms of financial resources, risk management and effective supervision, to enable the MA to make an adequate assessment of the proposal:</p> <p>Financial resources</p> <ul style="list-style-type: none"> <li>• cost of acquisition (in terms of capital base);</li> <li>• funding arrangement for the acquisition;</li> <li>• financial impact of the acquisition (in terms of capital adequacy and liquidity);</li> <li>• financial information of the company to be acquired;</li> </ul> <p>Risk management</p> <ul style="list-style-type: none"> <li>• nature of business of the company and its internal control systems;</li> <li>• limits and controls over the activities of the company;</li> <li>• reporting lines from the company to the AI;</li> </ul> <p>Effective supervision</p> <ul style="list-style-type: none"> <li>• whether the company is subject to any formal regulation and supervision in its place of incorporation;</li> <li>• details of any secrecy constraints on disclosure that may hinder the MA's overall effective consolidated supervision of the AI.</li> </ul> <p>The MA may refuse to grant approval if it is considered that the interests of depositors or potential depositors of the AI would be threatened by the proposed acquisition or establishment or acquisition of an overseas banking subsidiary.</p> <p>If adverse developments in a host country have rendered it difficult for the MA to exercise effective consolidated supervision on an AI's overseas operations in that country (e.g., new secrecy laws or restrictions), the BO also empowers the MA to attach conditions to or revoke the approval formerly given with regard to the establishment of overseas branches or representative offices.</p> <p>Regarding the establishment of overseas operations by a locally incorporated AI, the HKMA is responsible for assessing at the time of approval and ensuring on an ongoing basis that the country in which the overseas operation is situated does not have secrecy laws or restrictions that would prohibit the HKMA from exercising effective consolidated supervision. The HKMA will generally not grant approval for a locally incorporated AI to establish overseas operations in a country that has secrecy laws or restrictions that would inhibit the HKMA from exercising effective consolidated</p>
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	supervision.
<b>EC4</b>	The supervisor determines that the bank has, from the outset, adequate financial, managerial and organizational resources to handle the acquisition/investment.
<b>Description and findings re EC4</b>	As already mentioned under EC 3, in considering the acquisition or investment, the HKMA will have particular regard to the AIs' source of funds, impact on its capital adequacy and liquidity, future financial support implications, etc. From a management standpoint, the acquiring AI is expected to have mechanisms such as a project management team comprised of representatives from the relevant functions and external legal advisors to execute the acquisition or investment properly. Senior management of the acquiring AI should oversee the acquisition or investment process to ensure a smooth completion. If the acquiring AI is involved in the management of the acquired entity/investment, the HKMA will also assess factors such as the resource implication on the AI, its expertise in overseeing and managing the acquired entity/investment, group compliance oversight, etc.
<b>EC5</b>	The supervisor is aware of the risks that non-banking activities can pose to a banking group and has the means to take action to mitigate those risks. The supervisor considers the ability of the bank to manage these risks prior to permitting investment in non-banking activities.
<b>Description and findings re EC5</b>	<p>As discussed above under Principle 4, in Hong Kong, AIs may conduct non-banking financial activities that are under the purview of other domestic financial regulators. In such circumstances, they are required to obtain the authorization from and/or register with the appropriate regulatory bodies for conducting such activities and comply with the codes and standards issued by these bodies. As the front-line supervisor of AIs, the HKMA remains responsible for overall supervision of such activities in collaboration with the relevant regulators. The fact that the HKMA acts as the frontline supervisor enables it to observe the risks to AIs from such business.</p> <p><i>Investment in non-banking subsidiaries</i></p> <p>According to SPM CR-L-5 "Major Acquisitions and Investments: §87A" Paragraph 2.4.1, AIs are required to submit the following information to the HKMA for assessment:</p> <ul style="list-style-type: none"> <li>• degree of AI's involvement in managing and monitoring the business of the non-banking subsidiary/company; and</li> <li>• limits, controls and reporting procedures to be established over the activities of the subsidiary/company.</li> </ul> <p>According to SPM CS-1 "Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions", if the MA has supervisory concerns about the corporate structures or activities of the related entities of an AI, the MA may, depending on the level of risk posed to the AI by the structure or activities, take various remedial actions in relation to the AI to contain the risks. These include:</p> <ul style="list-style-type: none"> <li>• requiring the controller of the AI to restructure and consolidate financial services activities in or under the AI;</li> <li>• imposing restrictions on the AI's business relationship with its related entities;</li> </ul> <p>or</p>

	<ul style="list-style-type: none"> <li>• attaching conditions to the MA's approval to mitigate the risks or revoking the approval given under BO section 51A for the AI's establishment of the overseas subsidiary concerned.</li> </ul> <p>The supervisory practices described under EC 3 also apply (mutatis mutandis) to AIs' proposals to acquire or invest in companies that engage in non-banking activities.</p> <p>If the HKMA has concern about the potential risks posed by the proposed acquisition/investment to an AI, the MA may exercise relevant powers to attach conditions to its approval, restrict the AI's business relationship with the company to be acquired, or require the AI's controller to restructure and consolidate the business activities in or under the AI.</p> <p>The HKMA also collects information from AIs regularly on their securities, insurance, and MPF related activities so as to help the MA to assess the risks posed by such activities to individual AIs on an ongoing basis. AIs are required under BO section 63(2) to submit information on their MPF, securities and insurance related activities through the banking returns MA(BS)13, MA(BS)14 and MA(BS)15 respectively.</p>
<b>Additional Criteria</b>	
<b>AC1</b>	<p>The Supervisor reviews major acquisitions or investments by other entities in the banking group to determine that these do not expose the bank to any undue risks or hinder effective supervision. The supervisor also determines, where appropriate, that these new acquisitions and investments will not hinder effective implementation of corrective measures in the future.<sup>21</sup> Where necessary, the supervisor is able to effectively address the risks to the bank arising from such acquisitions or investments.</p>
<b>Description and Findings re AC1</b>	<p>Under BO section 51A, major acquisitions or investments by any locally incorporated holding company of a locally incorporated AI are subject to the MA's approval if the acquisition or investment in question is related to the establishment or acquisition of an overseas banking corporation such that the corporation becomes the subsidiary of the holding company. The MA may refuse to grant the approval to the entity concerned or may attach conditions to the approval. After granting the approval, the MA may at any time attach conditions to the approval granted or revoke the approval in order to address the risks concerned (e.g., if the acquired entities or investments are considered to pose undue risks to the group).</p> <p>For other entities of the banking group that are not the subsidiaries of the AI and that do not fall within BO section 51A, although the MA does not have a statutory power to require these entities to obtain the MA's approval before making any major acquisitions or investments, the MA, by virtue of the functions conferred on him by BO section 7, as well as his responsibility under BO section 70 and Schedule 7, Paragraph 4 to satisfy himself that the controllers of the AI remain fit and proper, can exercise his power under BO section 63(2A) to require any holding company of the AI or any subsidiary of any such holding company to submit such information as the MA may</p>

<sup>21</sup> Please refer to Footnote 20 under Principle 7, Essential Criterion 3.

	<p>reasonably require for the exercise of his functions under the BO.</p> <p>In addition, BO section 64 empowers the MA, for the purposes of identifying and supervising an AI's group linkages and potential associated risks, to require the AI to provide information on companies of which the AI has direct and indirect ownership (≥ 20 percent of share capital) or with which there are other significant linkages (e.g., have common controller).</p> <p>If an AI is part of a wider group that is headed by a common holding company, the MA will supplement its solo and consolidated supervision of the AI by a controller group review. As explained in SPM CS-1 "Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions", the MA is interested in both the holding company and the operations of the sister companies of an AI within the group to the extent that they could have a material impact on the AI. In the controller group review, the MA will assess the fitness and propriety of controllers taking into account, among other things, the effect of the holding company and the operations of any sister companies on the AI. Major acquisitions or investments by entities in the group are one of the areas that would be reviewed.</p> <p>Where there are supervisory concerns in view of the acquisition or investment in question, the MA may, depending on the level of risk posed to the AI, take any of the remedial measures described in SPM CS-1 Paragraph 6.2.5 to address the risks concerned, which include:</p> <ul style="list-style-type: none"> <li>• imposing restrictions on the AI's business relationship with its related entities if the MA is of the opinion that the business relationship is detrimental to the interests of the AI's depositors or potential depositors, by using the powers under BO section 52 subject to the relevant conditions for their exercise (see Principle 1 EC 6); or</li> <li>• attaching conditions to the approval granted under BO section 51A.</li> </ul> <p>The Banking Supervision Department (BSD) looks for assurance that entities in a banking group are not a source of weakness or hindrance of its effective supervision of AI under the banking group (including the implementation of corrective measures). Under the MA's enhanced framework for the consolidated supervision of banking groups, the MA may attach conditions to the approval granted under BO section 70 for such company to become an ultimate or immediate shareholder controller of the local AI and these conditions could include, among other things, to consult the MA for any proposal that would result in change to its group structure and not to carry on any business or activity without the MA's prior consent.</p> <p>If the case teams within the BSD have concerns that the acquisition or investment exposes the AI to potential risks or hinder effective supervision, the BSD will take appropriate measures to mitigate the risks. If necessary, the BSD may recommend the MA to exercise relevant powers under the BO to attach conditions for the authorization of the AI to ring fence its operations (e.g., to restrict AI's business relationship with the company to be acquired or to restrict its intragroup exposures to the company to be acquired).</p>
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<b>Assessment of Principle 7</b>	Compliant
<b>Comments</b>	<p>The HKMA has broad supervisory powers under the BO to review and approve or deny acquisitions or investments by banks. In conducting its review of proposals submitted by banks, the HKMA analyzes various criteria to ensure that the AI will not be exposed to undue risks. It also determines that the acquisition or investment will not negatively impact the HKMA's ability to conduct effective consolidated supervision.</p> <p>With regard to assessing whether major acquisitions and investments by other entities within the banking group will hinder effective implementation of corrective measures in the future, the HKMA currently has a process in place to conduct a thorough review and take any necessary actions to protect an AI. The focus on resolvability issues within the international supervisory community is very recent and the HKMA might want to discuss with supervisors in other jurisdictions how they are conducting such assessments in order to ensure that they stay current with internationally accepted norms as they develop.</p>
<b>Principle 8</b>	Supervisory approach. An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.
<b>Essential criteria</b>	
<b>EC1</b>	<p>The supervisor uses a methodology for determining and assessing on an ongoing basis the nature, impact and scope of the risks:</p> <ul style="list-style-type: none"> <li>(a) which banks or banking groups are exposed to, including risks posed by entities in the wider group; and</li> <li>(b) which banks or banking groups present to the safety and soundness of the banking system.</li> </ul> <p>The methodology addresses, among other things, the business focus, group structure, risk profile, internal control environment and the resolvability of banks, and permits relevant comparisons between banks. The frequency and intensity of supervision of banks and banking groups reflect the outcome of this analysis.</p>
<b>Description and findings re EC1</b>	<p><i>Overview</i></p> <p>The HKMA describes its risk based supervisory framework and methodology in its Supervisory Policy Manual (SPM SA-1). The framework is designed to enable a continuing assessment of the risk profile of individual AIs. The framework also seeks to establish a forward-looking view on the risk profile of AIs, to focus on the areas of greatest risk to an AI and to enable the HKMA to be proactive.</p> <p><i>Risk focus</i></p> <p>The risk-based supervisory framework focuses on eight major types of inherent risk i.e. credit, interest rate, market, liquidity, operational, legal, reputation and strategic risks. The results of the risk assessment are factored into the CAMEL rating system (please see EC2 for more details). The HKMA assesses the risks of AIs with regard to the level</p>

	<p>and direction of each of type of risk and respective risk management controls.</p> <p>The CAMEL review takes into account the examination findings, supervisory issues observed from on-going off-site surveillance of AIs, market intelligence, information and reports (e.g., auditors' reports, management letters, Board and management level committee meeting minutes) relating to corporate governance, management oversight, risk management and controls, and financial trends and changes of AIs.</p> <p>The SRP review determines the minimum statutory CAR of locally incorporated AIs under Pillar 2 and assesses the adequacy of the internal capital adequacy assessment process (ICAAP). The ICAAP must be submitted annually.</p> <p><i>Group wide</i></p> <p>The risk-based supervisory approach is complemented by a group-wide approach to supervision of banking groups (please see SPM CS-1 Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions). The methodology thus takes into account the consolidated risks of an AI's downstream operations (i.e. its offices, subsidiaries, associated companies, and joint ventures, both domestic and foreign). Where an AI is part of a wider group, the HKMA considers risks that could be posed to the AI by the holding companies and any sister companies. Prudential standards are applied and assessed on a consolidated as well as a solo basis.</p> <p><i>Risks posed to and from a banking group</i></p> <p>In determining the supervision strategy for an AI, the HKMA also considers the size of the AI, the critical functions and roles played by the AI, its place of incorporation, scale of retail banking business, the extent of its interconnection with other market players and the implication of these factors to the safety and soundness of the banking system.</p> <p>In terms of assessment of risks which banks or banking groups present to the safety and soundness of banking groups the HKMA uses data and analysis from its statistical team within BSD which monitors the banking sector. Coverage of the analysis includes capital adequacy, asset quality, credit growth, credit concentrations by industry, leverage and liquidity positions. The team performs sector wide as well as firm based microprudential data analysis to identify outliers. Such work supported the HKMA in taking measures in respect of material loan growth across AIs, including the temporary suspension of certain activities pending closer examination by the HKMA.</p> <p><i>Peer group review</i></p> <p>In addition, ad hoc thematic examinations are conducted on selected areas, and this facilitates peer group review and the ability to benchmark AIs' risk management practices and promote sound practices to the industry. In 2012, the HKMA conducted thematic examinations on property mortgage lending, Mainland-related business and renminbi business. For 2013, thematic reviews have focused on asset quality, credit growth, particularly in non-bank Mainland China exposures, and property mortgage lending.</p> <p><i>Specialist risk review</i></p>
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	<p>Furthermore, examinations of AIs' specific areas, such as treasury, securities, insurance, MPF-related business, e-banking and anti-money laundering / counter-financing for terrorism and Basel 2 models, are conducted by specialist examination teams. In selecting AIs for examination, the teams conduct their own analyses and draw on information from the case teams, including trend analysis, and analysis of risk management and internal controls, the business plan and the market context. The findings and conclusions are factored into the CAMEL rating review and the SRP review.</p> <p><i>Proportionate frequency and intensity of supervision</i></p> <p>The frequency and intensity of supervision depends on a variety of factors, such as size, types of business, place of incorporation, rate of business growth, financial standing and internal control systems of the AI, outcome of the HKMA's risk assessment and any supervisory concern over the AI. In general, AIs with higher risk profile (e.g., sizable retail banking business or less satisfactory internal and/or risk management controls) or AIs that are systemically important will be subject to more supervisory attention. For AIs' overseas banking subsidiaries and branches, the HKMA will also take into account the work of host regulators.</p> <p>The HKMA conducts a CAMEL review of all AIs and SRP review of all locally incorporated AIs at least every year and seeks to integrate the processes. However, this frequency can be increased and a review can be triggered at any time and a team will not postpone the review to the annual cycle if information emerges that suggests a review should take place sooner. There are an uneven number of CAMEL grades, and the HKMA exercises closer supervision when the AI's rating is at the mid- point or worse on the scale. It should be noted that the elements of the CAMEL can be and are updated continuously through the course of the year as supervisory information becomes available.</p> <p>The HKMA has an examination cycle that reflects the concept of "continuous risk based supervision." The frequency of on-site exams is higher for the more complex and systemic firms, and for firms where off-site surveillance identifies a heightened risk profile. The annual risk assessment (both CAMEL and SRP) ensures however that no AI can be without examination for an extended period.</p> <p><i>Assessment of AIs' resolvability</i></p> <p>The HKMA is in the course of introducing its own domestic framework for RRP for AIs, which will support the carrying out of resolvability assessments. Nonetheless discussions have already been held with major AIs. See also EC6.</p> <p>More generally, legislative reform being pursued is likely to result in the MA being designated as resolution authority (for AIs) and a resolution unit was established in 2013 to help discharge this function. It is intended that this unit shall work with the case teams of the HKMA on resolution planning and resolvability assessments.</p>
<b>EC2</b>	<p>The supervisor has processes to understand the risk profile of banks and banking groups and employs a well defined methodology to establish a forward-looking view of the profile. The nature of the supervisory work on each bank is based on the results</p>

	of this analysis.
<b>Description and findings re EC2</b>	<p>Details of the risk-based supervisory framework and how it is integrated into the HKMA's overall supervisory process and the CAMEL rating system are set out in the SPM module on Risk-based Supervisory Approach (SA-1). The CAMEL system itself was last refreshed and updated in 2007. It employs both quantitative and qualitative factors and while the quantitative data generates an important input, the system is designed to allow the overlay of supervisory judgment.</p> <p>The HKMA assesses and analyses the key business lines and functions of an AI, its business strategies and any planned introduction of new services and products. The HKMA considers the level of each of the eight types of inherent risks (i.e. credit risk, liquidity risk, market risk, interest rate risk, strategic risk, operational risk, reputation risk and legal risk) faced by the AI and the direction of these risks in the next 12 months. The HKMA also evaluates the risk controls in place to manage the inherent risks. Assessment of the AI's risk profile constitutes the basis for determining the scope for the risk-based supervisory strategy and further supervisory work.</p> <p>In addition, the HKMA has developed a framework for conducting a SRP for the purpose of Pillar 2 of the regulatory capital framework. This framework is designed to deliver a comprehensive, systematic and granular assessment of capital adequacy in relation to AIs' inherent risks and the quality of their risk management, and enhances the HKMA's capability in monitoring changes in AIs' risk profiles and management. Detailed criteria and standards used by the MA in conducting the SRP are made public in the SPM module on Supervisory Review Process (CA-G-5).</p> <p>The structured work of the SRP is mapped into the CAMEL analysis and this ensures that many elements of the AI's risks are considered from more than one angle – not only the capital implication but the holistic contribution to the risk profile of the AI. The CAMEL methodology is designed to place particular weight on the management function and a downgrade on this element is an automatic downgrade on the composite rating.</p> <p>The HKMA seeks to adopt a forward-looking view and to proactively act on emerging trends and potential risks that it identifies. Issues that the HKMA has identified in recent years, and where it intervened either through system wide requirements, enhanced reporting or thematic examinations across AIs include continued increase of AIs' non-bank exposures to Mainland China and exuberance in the Hong Kong property market. In examining the SRP and CAMEL analyses and templates, the assessors were able to confirm that attention is paid to forward looking indicators, although some indicators are more reactive and some areas, such as the analysis of strategic risk and business model may benefit from further refreshing.</p> <p>The forward looking analysis is particularly underpinned by the recently introduced "bottom-up" Supervisor-driven Stress Testing Program where individual retail banks are required to perform their own stress testing based on a uniform set of supervisory stress scenarios designed by the HKMA and report the test results to the HKMA. Banks are required to also submit to the HKMA their action plan to address the outcome of the stress test results.</p>

	<p>Apart from the “bottom-up” Supervisory-driven Stress Testing Program, the HKMA also conducts “top-down” solvency stress tests using prudential data on a quarterly basis to, from a forward-looking perspective, identify the vulnerabilities of individual banks and the banking system as a whole. The BSD follows up with individual banks which are found to have capital shortfall under the stress scenarios.</p>
<b>EC3</b>	The supervisor assesses banks’ and banking groups’ compliance with prudential regulations and other legal requirements.
<b>Description and findings re EC3</b>	<p>The HKMA monitors AIs’ and banking groups’ compliance with various prudential regulations and relevant legal requirements through off-site surveillance and on-site examinations.</p> <p><i>Review of periodic banking returns</i> The HKMA reviews periodic banking returns on both solo and consolidated bases submitted by AIs to ensure compliance with the relevant statutory and prudential requirements. In particular, the HKMA reviews the returns on capital adequacy, liquidity, large exposures and the certificate of compliance. The certificate of compliance is not intended as a “zero tolerance” instrument but the HKMA has found it has been an effective discipline on the management of the AIs to ensure that they maintain the supervisory ratios and requirements that they have certified in their submission.</p> <p><i>Review of external auditor reports</i> Additionally, on an annual basis, the MA requires AIs to submit reports prepared by external auditors opining, among other things, the correctness of return reporting, adequacy of internal control systems for compilation of returns, and compliance with the BO regarding large exposures, risk concentration, disclosure of information, CAR and liquidity. The reports are commissioned under BO sections 63(3) and 63(3A) and prepared by AIs’ external auditors.</p> <p><i>Review of the results of self-assessment on specific areas conducted by AIs</i> The HKMA requires AIs to conduct regular and ad hoc self-assessments on specific areas (e.g., e-banking and operational risks and code of banking practice) to review their compliance with the requirements set out in the relevant SPM modules and industry codes.</p> <p><i>Review of the reports submitted by holding companies</i> Under the enhanced consolidated supervision framework implemented in 2013, the unregulated immediate holding company (IHC) of a local bank is required, by means of conditions attached to the consent under BO section 70 given to the IHC to be a controller of the AI, to observe prudential standards and other requirements “as if the IHC were a local bank” where appropriate.</p> <p>At the ultimate holding company (UHC) level, the UHC is required, by means of conditions attached to the consent under BO section 70 given to the UHC to be a controller of the AI, to submit regular information.</p>

	<p><i>On-site examinations</i></p> <p>In examining the adequacy of AIs' systems and controls in ensuring their compliance with prudential regulations, regulatory requirements and internal policies, the HKMA reviews areas such as:</p> <ul style="list-style-type: none"> <li>• AIs' management oversight;</li> <li>• AIs' relevant risk management systems and internal controls to ensure their compliance;</li> <li>• AIs' compliance and internal audit functions;</li> <li>• AIs' management information system and reporting process to assess whether the information captured by AIs is comprehensive, accurate and timely to facilitate AIs' management to monitor AIs' compliance;</li> <li>• AIs' relevant process (e.g., AIs' calculation of CAR or liquidity ratio) for complying with specific statutory requirements.</li> </ul>
<b>EC4</b>	<p>The supervisor takes the macroeconomic environment into account in its risk assessment of banks and banking groups. The supervisor also takes into account cross-sectoral developments, for example in non-bank financial institutions, through frequent contact with their regulators.</p>
<b>Description and findings re EC4</b>	<p>The HKMA established a Financial Stability Surveillance (FSS) Division in 2011, which is responsible for the surveillance of financial stability issues.</p> <p>The FSS Division produces regular focused macro-financial stability analyses which form the basis for the deliberation and formulation of appropriate policy responses by the Macroprudential Surveillance Committee (MSC) during bi-monthly meetings. The FSS Division supports the works of MSC. The functions of the MSC are to:</p> <ul style="list-style-type: none"> <li>• identify potential risks and threats to the monetary and financial system in Hong Kong and discuss possible measures to address such risks</li> <li>• review existing measures for managing risks in the monetary and financial system to identify possible gaps and ensure the adequacy of these measures</li> <li>• encourage cross-department sharing of relevant information on macro surveillance with a view to enhancing macro surveillance capability of the HKMA</li> </ul> <p>The MSC comprises the senior executives and relevant executive directors of the HKMA and has been a fertile forum for surfacing wider issues that can affect the banking sector and which spark initiatives which may include thematic on-site examinations, surveys or reviews. The MSC is thus a conduit for the macro angle to influence the work within the microprudential area of the HKMA.</p> <p>To date the MSC does not have a formal decision making role with respect to macroprudential tools, such as decisions on LTV, but the senior staff who sit on the MSC are those who advise and contribute to such decisions and the MSC is thus a forum for analysis and debate on these issues. Nevertheless, the MSC is not regarded as a discussion forum but a committee that seeks to launch specific action relating to risks that are identified. Looking ahead it is possible that the HKMA may decide to use this forum as a decision making committee for the use of the countercyclical capital</p>

	<p>buffer that is required under Basel 3.</p> <p>The FSS Division's macro-financial stability analysis is a major input into the MSC discussions, helping to identify risks or issues that may need to be explored. When work from the FSS identified issues, the HKMA response has included enhanced data collection and conducting further stress testing to analyze the implication of such issues at system wide and firm wide level. In addition FSS input has allowed the HKMA to put supervisory effort (including through recommendations stemming from on-site examinations) into encouraging and as necessary requiring banks to enhance their own management information in respect of such issues.</p> <p>Market issues are also discussed more frequently at other meetings of various task forces, attended by the MA and the senior officers of the HKMA. If members of the task forces identify issues that could have risk implications for the banking sector, appropriate follow-up actions (such as conducting tailor-made stress tests on AIs under scenarios that could transpire from those issues) will be taken. In addition to the tailor-made stress test mentioned above, the HKMA conducts quarterly stress tests to assess the resilience of the banking sector to risks and vulnerabilities within the financial system, taking into account current macroeconomic indicators and market events.</p> <p>The HKMA obtains cross financial sector information through cooperation and information sharing with other regulators (e.g., SFC, IA and MPFA) under the MoU of cooperative supervisory arrangements as well as the arrangements of CFR and FSC. Although these groupings are at a senior level, such forums are important in order to ensure that decisions can be made to take action in relation to agreed identified risks. The HKMA considered that these groups had been able to identify and begin to coordinate in respect of common risks (such as AML where all financial sectors are enhancing their resources). These senior groupings are also supplemented by other relationships at working levels such as on conduct issues with the SFC, IA and MPFA.</p>
<b>EC5</b>	<p>The supervisor, in conjunction with other relevant authorities, identifies, monitors and assesses the build-up of risks, trends and concentrations within and across the banking system as a whole. This includes, among other things, banks' problem assets and sources of liquidity (such as domestic and foreign currency funding conditions, and costs). The supervisor incorporates this analysis into its assessment of banks and banking groups and addresses proactively any serious threat to the stability of the banking system. The supervisor communicates any significant trends or emerging risks identified to banks and to other relevant authorities with responsibilities for financial system stability.</p>
<b>Description and findings re EC5</b>	<p>The HKMA places much emphasis on analysis of trends, developments and risks in the banking system. The following departments contribute to this work.</p> <ul style="list-style-type: none"> <li>• The HKMA, in addition to conducting institution-specific analysis, compiles macro-level reports including trend analysis (e.g., credit growth, profitability, asset quality), risk concentrations (e.g., credit risk by economic sector), and factor analysis (e.g., factors contributing to the banking sector's capital level).</li> <li>• The FSS Division constructs comprehensive and scenario-based analyses. The scenarios are usually based on the FSS Division's assessment of potential</li> </ul>

	<p>vulnerabilities of the banking sector under specific stress scenarios. The FSS Division also constructs scenarios that reflect the expected risk transfer mechanism and contagion paths, which in turn, could hit individual AIs in Hong Kong and whether any AIs in Hong Kong might be unable to withstand shocks and trigger contagion in the banking sector. Topics in the past couple of years have included the bursting of the property sector and negative impact of quantitative easing measures, significant capital outflows, emerging markets sovereign risks, etc.</p> <ul style="list-style-type: none"> <li>• The Research Division uses banking data as inputs to its macroeconomic models. The results (e.g., relations between GDP shock and credit loss rates) are used by BSD in conducting quarterly stress tests. In addition, topic analyses are performed from time to time, e.g., evaluation of the effectiveness of the HKMA's supervisory policy on property mortgage lending.</li> </ul> <p>Additionally, ad hoc analyses may also be performed to gauge risks stemming from outside the banking sector. For instance, the HKMA has investigated and monitors spillover effects of tightened macroprudential policies in the property market as clients turned to unregulated money lenders for mortgage funding.</p> <p><i>Communication and cooperation</i></p> <p>Trends and concerns are communicated to the Council and committees noted below where membership is drawn from a variety of sectors including AIs, accounting firms, other financial regulators, bodies such as Consumer Council as well as government officials and members from the Legislative Council:</p> <ul style="list-style-type: none"> <li>• Council of Financial Regulators</li> <li>• Financial Stability Committee</li> <li>• Banking Advisory Committee</li> <li>• DTC Advisory Committee</li> </ul> <p>In addition, the HKMA publishes "The Half-Yearly Monetary and Financial Stability Report." The report contains a section on "Banking Sector Performance" which reveals the trends (e.g., credit growth, profitability and capitalization, liquidity and funding), risks and key performance indicators of banking sector.</p>
<b>EC6</b>	<p>Drawing on information provided by the bank and other national supervisors, the supervisor, in conjunction with the resolution authority, assesses the bank's resolvability where appropriate, having regard to the bank's risk profile and systemic importance. When bank-specific barriers to orderly resolution are identified, the supervisor requires, where necessary, banks to adopt appropriate measures, such as changes to business strategies, managerial, operational and ownership structures, and internal procedures. Any such measures take into account their effect on the soundness and stability of ongoing business.</p>
<b>Description and findings re EC6</b>	<p>At the time of the assessment, the HKMA was engaged in working to introduce a domestic framework for RRP for AIs, which will support the carrying out of resolvability assessments. The HKMA has a record of requiring firms to amend group structures (including establishment of holding companies and the subsidiarization of branches) in addition to requiring changes to management and business focus and thus envisages</p>



	<p>that it will have a close engagement with the AIs to eliminate any barriers to orderly resolution once identified.</p> <p>As part of the preparatory work for introducing the domestic resolution regime to meet the FSB's standards in its Key Attributes, the HKMA indicated that the HKSAR Government will propose that the relevant authorities (either the regulatory and/or resolution authority) should be directly empowered to require AIs, where necessary, to adopt measures to improve their resolvability. While the MA's existing intervention powers under the BO in particular under section 52 may be used to this end, where specific statutory conditions are met, the HKMA indicated that HKSAR Government considers explicit legislative powers to be advantageous to improve resolvability (in order to fully comply with the requirement of the Key Attributes). (please see CP11).</p> <p>While the HKMA had not yet completed a full local exercise to assess resolvability, at the time of the assessment, information gathering, analysis and discussion with firms was underway. Banks with whom the assessors met indicated that they have already held discussions with the HKMA on this topic. The HKMA's active participation in CMGs for G-SIBs has further involved its discussion and analysis of the major systemic firms in Hong Kong.</p>
<b>EC7</b>	The supervisor has a clear framework or process for handling banks in times of stress, such that any decisions to require or undertake recovery or resolution actions are made in a timely manner.
<b>Description and findings re EC7</b>	<p>To expedite the handling of banking crisis related to an AI or AIs, the HKMA has established internal policies and procedures collated within the "Contingency Plan for Handling Banking Crisis." The contingency plan which was made available to the assessors, provides detailed processes and procedures for a range of issues including for handling various crisis scenarios, a summary of the intervention/control powers of the MA under the BO, and responsibilities and contact information of relevant officers and parties in handling the crisis. The HKMA conducts crisis simulation exercises on the banking sector and together with the FSTB and the relevant regulators on cross-market, to test the execution of the contingency plan and to identify any need for enhancements. While the contingency plan sets out orderly practice in a crisis situation, it is not binding on the MA who can, should need arise, deploy the supervisory tools and approaches as appropriate to the urgency and specifics of the situation.</p> <p>In general, when an AI shows signs of significant stress (with respect to liquidity and/or solvency), the HKMA will activate the emergency process. Among the first steps are urgent meetings with the management (and external auditor where necessary and feasible) of the AI concerned and on-site examination as may be necessary to confirm the nature and scale of the problem and to establish, in particular, whether the problem is a transitory liquidity problem or a fundamental solvency issues. In the case of an AI incorporated outside Hong Kong, the HKMA would also maintain close liaison with the home supervisor.</p> <p>Features of the process include early notification to senior management, the convening of the BSRC to evaluate the situation and advise the MA and the</p>

	<p>establishment of a command centre. Communication with other relevant regulators and the HKSAR Government as needed is also taken into account.</p> <p>The HKMA confirmed that cooperation and communication between the FS and the MA is very close on a day to day basis. Hence the escalation of an issue when stress or crisis emerges is immediate and there are no practical delays should the MA have to consult formally with the FS, for example, if using intervention powers under BO section 52.</p> <p>As noted above, the HKMA is working to introduce a domestic framework for RRP for AIs. Legislative reform being pursued are likely to result in the MA being designated as resolution authority (for AIs) and a resolution unit was established in 2013 to help discharge this function. It is intended that this unit would work with the case teams of HKMA on resolution planning and resolvability assessments. A new SPM module on resolution planning is expected to be issued in 2014.</p>
<b>EC8</b>	Where the supervisor becomes aware of bank-like activities being performed fully or partially outside the regulatory perimeter, the supervisor takes appropriate steps to draw the matter to the attention of the responsible authority. Where the supervisor becomes aware of banks restructuring their activities to avoid the regulatory perimeter, the supervisor takes appropriate steps to address this.
<b>Description and findings re EC8</b>	<p><i>Bank-like activities that are performed outside the bank regulatory perimeter</i></p> <p>To date bank-like activities performed outside the bank regulatory perimeter have not been detected. Nevertheless, were such activities to be carried on by an unauthorized institution which is regulated by other financial regulators (e.g., SFC, IA and MPFA), the MA would raise the issue with the responsible authority requiring the appropriate remedial actions. If appropriate, the MA would refer the case to the Department of Justice of the HKSAR Government.</p> <p><i>AIs restructure their activities to avoid the regulatory perimeter</i></p> <p>Should the AI concerned fail to respond appropriately to the request by the MA to rectify its affairs, the MA would be ready to exercise his powers under the BO (such as sections 52 and 16) to require the AI to take the necessary measures (e.g., unwind the transactions and cease the activities). Given the AI's restructuring of their activities to avoid the regulatory perimeter, the HKMA would also assess the implications with respect to the competence and integrity of the AI's senior management and directors concerned and take appropriate action. (See CP11 for more extensive details).</p>
<b>Assessment of Principle 8</b>	Compliant
<b>Comments</b>	The HKMA executes an excellent supervisory approach which combines sound risk analytical techniques and a broad range of inputs. The use of thematic examinations and the integration between the SRP and CAMEL methodology provides a clear and forward looking basis for a holistic risk assessment process. The HKMA has created a disciplined and responsive approach on the "continuous" risk based principle and intervenes quickly with institutions when issues start to emerge. The supervisory process is informed by active consideration of the wider macro context and tools, and techniques to enhance this approach continue to be developed, which is important as

	<p>this is a general area for development within the supervisory community. Moving forward, however, greater consideration could be given to cross sectoral issues in the context of day to day supervision of AIs and their wider groups.</p>
<b>Principle 9</b>	<p>Supervisory techniques and tools. The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks.</p>
<b>Essential criteria</b>	
<b>EC1</b>	<p>The supervisor employs an appropriate mix of on-site<sup>22</sup> and off-site<sup>23</sup> supervision to evaluate the condition of banks and banking groups, their risk profile, internal control environment and the corrective measures necessary to address supervisory concerns. The specific mix between on-site and off-site supervision may be determined by the particular conditions and circumstances of the country and the bank. The supervisor regularly assesses the quality, effectiveness and integration of its on-site and off-site functions, and amends its approach, as needed.</p>
<b>Description and findings re EC1</b>	<p>The HKMA's risk-based supervisory approach consists of six key steps:</p> <ol style="list-style-type: none"> <li>(1) understanding the AI;</li> <li>(2) assessing the risk;</li> <li>(3) planning supervisory work;</li> <li>(4) defining examination activities</li> <li>(5) performing risk-focused on-site examination, reporting the findings and reviewing the CAMEL rating; and</li> <li>(6) conducting continuing off-site supervision including supervisory actions.</li> </ol> <p>Since the 2008 global financial crisis, the HKMA has streamlined its workflows in order to (i) enhance the effectiveness of its supervisory work in a more complex regulatory environment and (ii) incorporate macroprudential supervisory actions in a more systematic manner. As a result, the risk-based supervisory approach was enhanced in a number of ways, including:</p> <ul style="list-style-type: none"> <li>• integrating risk assessment into the SRP;</li> <li>• separating prudential and conduct supervision.; and</li> <li>• increasing supervisory focus from macro-prudential perspective – recent examples including work on residential mortgage lending, fund flows, credit growth in particular non-bank Mainland China exposures (NBMCE).</li> </ul> <p>Given the above enhancement of supervision during the execution of the risk-based supervisory framework, in 2012, the HKMA conducted 288 on-site examinations (including both regular and thematic examinations) and 198 off-site reviews.</p>

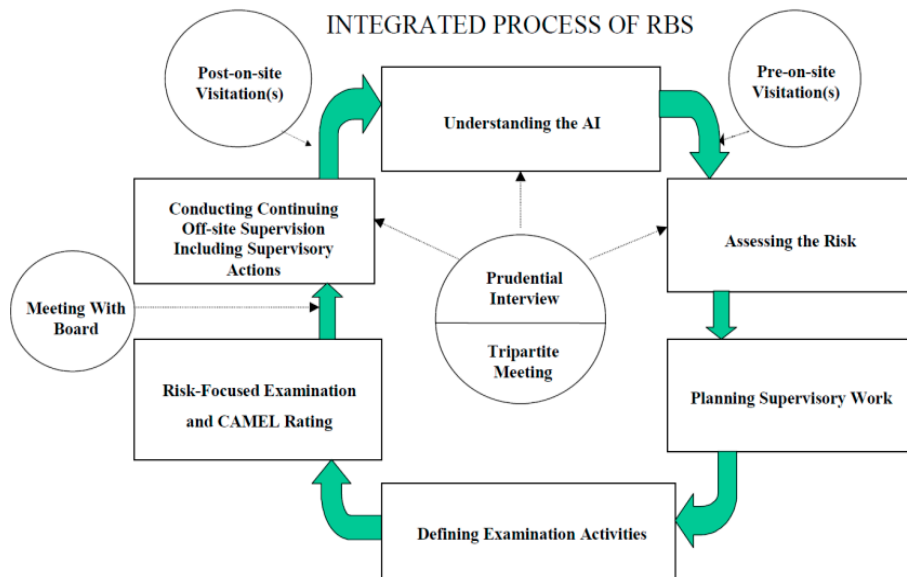
<sup>22</sup> On-site work is used as a tool to provide independent verification that adequate policies, procedures and controls exist at banks, determine that information reported by banks is reliable, obtain additional information on the bank and its related companies needed for the assessment of the condition of the bank, monitor the bank's follow-up on supervisory concerns, etc.

<sup>23</sup> Off-site work is used as a tool to regularly review and analyze the financial condition of banks, follow up on matters requiring further attention, identify and evaluate developing risks and help identify the priorities, scope of further off-site and on-site work, etc.

As noted in CP8, at a minimum, however, the HKMA will conduct regular on-site examinations of locally incorporated banks at least once every year while the frequency for AIs incorporated outside Hong Kong is determined by its risk profile and degree of reliance that the HKMA considers it can place on the home supervisor. Frequency can be 3-5 years if assessed at a lower level. Ongoing off-site surveillance is in place for all AIs, and may trigger follow up with additional on-site work (including thematic examinations). The duration of an on-site examination might be between two weeks and several months depending on the depth and breadth of the scope. For major institutions there will be multiple examinations each year.

The on-site and off-site supervision is also complemented by the Supervisory Review Process (SRP) assessment in the case of locally incorporated AIs. The four main components of the SRP are (a) the assessment of the non-Pillar 1 risks (e.g., as set out in the Basel framework and including concentration risks etc); (b) risk management and internal controls; (c) assessment of the firms' internal capital adequacy assessment process (ICAAP) to withstand risk, including an assessment of the AI's capital resilience to withstand certain impact; and (d) corporate governance. The overall supervisory integrated process of risk based supervision is illustrated below

The HKMA undertook a review of its banking supervisory processes in 2011/12 and is executing the action plan of this review. One of the main decisions coming out of the review is the development of a quality assurance framework for the HKMA and ways to enhance the effectiveness, efficiency and consistency of the bank supervision process and practices. This work is in early stages of development at present.



**EC2**

The supervisor has a coherent process for planning and executing on-site and off-site activities. There are policies and processes to ensure that such activities are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs, and that there is effective coordination and information sharing between the on-site

	and off-site functions.
<b>Description and findings re EC2</b>	<p><i>Off-site supervision</i></p> <p>The HKMA's ongoing supervision of AIs is operated under a "case team system." All AIs are distributed among Division Heads within the HKMA. Within each division, each AI is assigned to a case team, comprising the Division Head, a case Senior Manager and a case Manager, for the AI's overall supervision. Each case Manager / Assistant Manager, in turn, assumes the day-to-day supervisory responsibility for a portfolio of AIs (the number of which, depending on their complexity, may range from one to seven). The case team performs the annual full assessment of the risk profile of the AI. This assessment is used as the basis for formulating the on-site examination plan and terms of reference of on-site examination of the AI. The annual off-site review is an extensive and detailed process, requiring the submission of a broad range of updated information on qualitative and quantitative issues from the AI. The assessors were able to see examples of the work based on the off-site work, including some major supervisory findings and actions arising from the off-site work.</p> <p><i>On-site supervision</i></p> <p>There are several on-site examination teams within each HKMA banking supervision division.</p> <p>The scope and frequency of examination will depend, inter alia, on the issues and concerns identified during the risk-based supervisory process (See also CP8 EC1). As also noted in a number of other CPs, there are specialized teams of experts who can perform both on and off-site activities. At present, specialist teams cover topics including AML, treasury operations, e-banking, liquidity risk management, operational risk management (ORM), residential mortgage lending, renminbi business and Mainland-related business. The on-site teams make use of "examination checklists" (for example on liquidity, market risk, interest rate risk, credit risk). The use of these checklists depends on a wide and expert knowledge by the on-site examiner and cannot be used in a "tick box" manner but require supervisory judgment. The checklists do, however, provide a tool to ensure that an appropriate range of issues are addressed and the HKMA monitors on-site examinations through, for example, internal audit, to ensure consistency of approach between institutions.</p> <p><i>Coordination between on-site and off-site</i></p> <p>Structurally, integration between on and off-site is supported by regular dialogue, including meetings, between the relevant senior management, and well specified documentation and training to support staff's activities. In practical terms, the on-site team communicates findings to the off-site case team, either at the conclusion of the examination or sooner if material issues emerge. Typically, the senior managers of both the on and off-site teams attend the exit meeting. The off-site case team then takes the on-site findings into account in the yearly off-site review, which includes the Pillar 2 SRP and the CAMEL rating review. It is the results of this review that forms the basis of the case team's supervisory plan over the next twelve months. It should be noted that updating the CAMEL assessment is not confined solely to this review period – the CAMEL is updated in response to relevant supervisory findings that emerge during the entire supervisory cycle.</p>

	<p><i>Policies and process for thoroughness and consistency</i></p> <p>The on-site process is supported by manuals and standardized examination working papers, checklists and examination report for staff guidance. The assessors were able to examine such papers and found them to be detailed and well focused.</p>
<b>EC3</b>	<p>The supervisor uses a variety of information to regularly review and assess the safety and soundness of banks, the evaluation of material risks, and the identification of necessary corrective actions and supervisory actions. This includes information, such as prudential reports, statistical returns, information on a bank's related entities, and publicly available information. The supervisor determines that information provided by banks is reliable<sup>24</sup> and obtains, as necessary, additional information on the banks and their related entities.</p>
<b>Description and findings re EC3</b>	<p>AIs are required to submit returns on a regular basis including prudential and statistical information (e.g., capital adequacy, large exposure, balance sheet information). Such data also includes regular surveys (please see CP10). In addition the HKMA collects ad hoc data and information from AIs as necessary. For example, during the recent European sovereign debt crisis, AIs were required to submit information on exposures to the GIIPS countries (e.g., the amount and types of credit exposures). The HKMA also monitors publicly available information such as press releases and the annual financial report/financial disclosure statements issued by the AI. The HKMA also uses its on-site activities to gather information and data relating to the supervised institutions. In particular, documents relating to the AI's internal systems and controls, such as risk management policies and procedures, meeting minutes of board level and senior management level committees, are collected.</p> <p>Further, the HKMA will use its home/host supervisory relationships, including colleges of supervisors to obtain information and gain a wider view. When available the HKMA will assess the views of external credit rating agencies. In addition to reports commissioned under section 63 of the BO, the HKMA also takes into account the views of external auditors on the financial position and internal control environments of individual AIs and the banking industry as a whole through regular meetings with them (e.g., Tripartite meetings and bilateral meetings). Information sources are further complemented by interviews with senior staff of AIs' business units.</p> <p><i>Reliability of information collected</i></p> <p>The reliability of supervisory returns is primarily tested through the annual report of the external auditors required by the HKMA (under the BO sections 63(3) and (3A)). The external auditors are required to state whether banking returns are correctly compiled by AIs, whether the systems of control for the compilation of banking returns are adequate, and whether there are areas concerning the internal control systems of AIs that require the special attention of the HKMA. The HKMA also carries out internal validation tests on the returns.</p>
<b>EC4</b>	<p>The supervisor uses a variety of tools to regularly review and assess the safety and soundness of banks and the banking system, such as:</p>

<sup>24</sup> Please refer to Principle 10.

	<p>(a) analysis of financial statements and accounts;  (b) business model analysis;  (c) horizontal peer reviews;  (d) review of the outcome of stress tests undertaken by the bank; and  (e) analysis of corporate governance, including risk management and internal control systems.</p> <p>The supervisor communicates its findings to the bank as appropriate and requires the bank to take action to mitigate any particular vulnerabilities that have the potential to affect its safety and soundness. The supervisor uses its analysis to determine follow-up work required, if any.</p>
<b>Description and findings re EC4</b>	<p>The HKMA assesses the AI's overall risk profile through a range of supervisory tools including analyses of banking returns, interim and annual financial statements, results of the off-site reviews and on-site examinations, and review of other relevant information obtained from prudential interviews including business plan, AI's risk management reports and stress testing results. Horizontal peer reviews are conducted to identify outliers AIs in different lines of business.</p> <p>The HKMA uses the following tools:</p> <ul style="list-style-type: none"> <li>• Analysis of the financial position of firms at a point in time, and over time (including trend analysis)</li> <li>• Peer group comparison including with respect to the financial and operational performance (e.g., review ROE, ROA, cost-to-income ratio, loan loss ratio, etc. of a group of banks which focus on private banking business, property lending business, or consumer lending business, etc.) to identify whether a particular bank runs businesses in a less prudent manner or not and, if so, why (business model analysis)</li> <li>• Analysis of the business model of a particular business line with respect to risk management systems and internal controls (business model analysis). The HKMA noted that for the entities that are part of global groups, the supervisors' ability to challenge the global strategy is more limited, but this does not preclude the HKMA's ability to challenge local practices should concerns be identified.</li> <li>• Review the outcome of stress tests undertaken by individual AIs</li> <li>• Conduct internal supervisory stress tests</li> <li>• Conduct thematic examinations (e.g., corporate governance, systems of remuneration, stress testing program, etc.)</li> <li>• Review of an AI's internal audit reports</li> <li>• Review of reports prepared by independent third parties (e.g., consultancy firms or external auditors) commissioned by the AI with a view to seeking other parties' view on the AI's risk management and internal control environment. This is supplemented by on-site examination.</li> <li>• Review of Board and committee structure (including Audit, Risk Committee etc). Please see also CP14.</li> </ul> <p>AIs must submit the results of their firm-wide stress tests, including any actions taken</p>

	<p>in response to the results generated and the supporting analyses and justifications for the actions taken (SPM IC-5: Stress-testing). Where the HKMA's assessment reveals material shortcoming in an AI's stress-testing program (or that the results generated from the program are not adequately attended to or acted upon), the AI must provide a detailed plan of corrective actions and follow-up on its implementation.</p> <p>The HKMA also makes use of analyses and studies carried out by the FSS Division and the Research Department in designing its supervisory work on AIs. For instance, in 2013, studies by the FSS Division and the Research Department identified the property market as a major risk factor, together with linkages between the Mainland property market and the shadow banking system. In response the HKMA carried out ad hoc scenario stress tests using both existing regulatory data and information from ad hoc requests to individual firms.</p> <p>When issues are identified the institution is informed by the HKMA and required responses might include, for example, additional risk limits to contain the risk, implementing additional risk management systems and controls to strengthen the control environment, etc. Where analysis suggests that there is a system wide issue, such as very strong loan growth, or aggressive growth in residential property lending (these factors are both features that have been identified in the recent past), the HKMA may consider introducing new supervisory requirements (e.g., for example, perhaps lowering the LTV ratio). The assessors saw examples of such analyses and follow up actions.</p> <p>Please see EC8 for more details on how the HKMA communicates supervisory findings to AIs.</p>
<p><b>EC5</b></p>	<p>The supervisor, in conjunction with other relevant authorities, seeks to identify, assess and mitigate any emerging risks across banks and to the banking system as a whole, potentially including conducting supervisory stress tests (on individual banks or system-wide). The supervisor communicates its findings as appropriate to either banks or the industry and requires banks to take action to mitigate any particular vulnerabilities that have the potential to affect the stability of the banking system, where appropriate. The supervisor uses its analysis to determine follow-up work required, if any.</p>
<p><b>Description and findings re EC5</b></p>	<p>As noted in CP8 EC4, the work of the FSS Division and Research Departments constitute important inputs into the system wide analysis and supervisory decision making of the HKMA. Also, the MA, the SFC, the IA and FSTB meet regularly to discuss regulatory issues, monitor cross-market risks and review issues that may have implications for financial stability.</p> <p>Further, the FSC was set up in 2000 to monitor the functioning of the financial markets in Hong Kong, including the banking, debt, equity, insurance and related markets; and consider issues with possible cross market and systemic implications. It reports to the FS regularly and at any time where necessary. The committee is chaired by the SFST of the HKSAR Government and comprises the MA, the Chief Executive Officers of the SFC and the IA.</p> <p>The HKMA conducts periodic supervisory stress tests on all locally incorporated banks and major foreign bank branches, including:</p>



	<ul style="list-style-type: none"> <li>• ability to withstand a run based on prescribed daily deposit run-off rates.</li> <li>• quarterly top-down stress test on capital adequacy, profit and asset quality assuming severe deterioration in macroeconomic performance (e.g., drop in GDP growth, hike in market interest rates, slump in property prices, slow down of the economic activities in Mainland China and the world, etc.)</li> </ul> <p>In 2012, the HKMA also introduced a bottom-up supervisor-driven stress test. Selected AIs, mainly retail banks, undertook the stress test using their own approach and methodologies but applying a scenario pre-set by the HKMA.</p> <p>The HKMA off-site case teams communicate the results and findings of the stress tests to the AI including, as necessary, sharing the risk factors that could pose significant impact on their capital, and for IRB banks, their procyclicality against the whole banking sector. Case teams also take the stress test results into account when reviewing the capital planning of AIs. Where necessary, AI's are required to mitigate particular vulnerabilities, e.g., credit risk arising from holding of subordinated debt. Similarly, if an AI is found to be an outlier in a stress test the HKMA meets with the AI's management to discuss and require remedial measures.</p> <p>The HKMA communicates its assessment of any emerging risks across banks and to the banking system as a whole through its public Half-Yearly Monetary and Financial Stability Report. The weekly meeting with the Chairman of the Hong Kong Association of Banks and quarterly meeting with the Association, are other important opportunities for the HKMA to convey key messages concerning the banking system vulnerabilities.</p>
<b>EC6</b>	<p>The supervisor evaluates the work of the bank's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk.</p>
<b>Description and findings re EC6</b>	<p>The MA places strong emphasis on the work performed by the internal audit function of an AI. The SPM explicitly states (IC-2) that the HKMA will determine the effectiveness of the internal audit function by evaluating the extent to which it can ensure that the internal risk management and control policies and processes are complied with, and continue to be sufficient and appropriate for an AI's existing businesses and planned business developments. The HKMA will also assess whether the internal audit function is able to make suitable recommendations, where necessary, to improve the effectiveness of those policies and processes.</p> <p>The SPM also sets out the HKMA's expectations on the key role, responsibilities and qualities of an AI's internal audit function (IAF), and describes the HKMA's approach in assessing effectiveness of the IAF. The IAF is expected to provide an independent assessment of compliance, reliability, continuity of management, accuracy of records and financial reports, efficiency of operations, and effectiveness of systems and processes for risk management and control.</p> <p>The HKMA has also laid down internal standards and guidance for determining the extent to which it can rely on work performed by the internal auditors of an AI. The assessment criteria address independence, competence and adequacy of work performed. From time to time the HKMA will require the IAF of an AI to carry out work</p>

	<p>– sometimes in the context of a thematic review. In these cases feedback is given to the AIs if concerns are identified in the work that has been produced. Firms with whom the assessors spoke confirmed that feedback was received following such exercises.</p> <p>Evaluation of the internal audit function comprises both off-site reviews and on-site examination. The HKMA requires the AI to submit documentation and information (SPM IC-2) and will also conduct meetings with relevant parties. The HKMA follows the guidance set out in SPM IC-2 when verifying whether the key determinants of an effective internal audit function are in place. Meetings to discuss and probe the IAF include the High-level meetings with the Board or the Audit Committee, on-site examinations discussions with the IAF, Prudential interviews with senior management of AIs and their internal auditors - meetings with internal auditors may also be separately arranged - tripartite meetings with external auditors (or an outsourcing vendor), and bilateral meetings with home supervisors of the Hong Kong branches or subsidiaries of foreign bank.</p> <p>Please see also CP 26 EC 5.</p>
<b>EC7</b>	<p>The supervisor maintains sufficiently frequent contacts as appropriate with the bank's Board, non-executive Board members and senior and middle management (including heads of individual business units and control functions) to develop an understanding of and assess matters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems and internal controls. Where necessary, the supervisor challenges the bank's Board and senior management on the assumptions made in setting strategies and business models.</p>
<b>Description and findings re EC7</b>	<p>The HKMA considers meetings with the various levels of an AI on both regular and ad hoc basis to be an integral part of the supervisory process (SPM SA-1). The HKMA places a particular priority on establishing a formal and direct communication channel with the board of each bank (SPM CG-1). The HKMA will therefore normally meet at least once a year with the full board, audit committee or risk management committee of each locally incorporated licensed bank. In the context of this meeting, the HKMA presents its own assessment of the institution as well as a benchmarking of the institution's performance relative to its peer group and the sector more broadly. The HKMA also uses this opportunity to communicate the issues and matters to which the HKMA requires the Board to pay attention. The Board is also invited to engage in discussion with the HKMA and raise issues of concern.</p> <p>The HKMA regards this meeting as a valuable opportunity to understand how Board members evaluate the risk management and internal control effectiveness, quality of senior management and the overall safety and soundness of the AI.</p> <p>Aside from the Board/Board Committee meetings as part of the annual assessment process, the HKMA also meets the full Board or individual board members to discuss ad hoc supervisory issues requiring directors' immediate attention. Please see also EC8.</p> <p>Below the Board level, the HKMA maintains regular supervisory contacts with all levels of management of AIs through various types of meetings. The frequency of and issues to be discussed in these meetings will depend to some extent on the materiality and</p>

	<p>nature of prudential concerns identified in the on-going supervisory process. While the HKMA will hold ad hoc meetings with the appropriate level of management (including unit heads), there are regular meetings with senior management following a comprehensive annual off-site review and at the exit meeting of an on-site examination. Issues relating to the business plan and strategy, profitability, corporate governance, asset quality, liquidity and risk management will be covered when discussing observations drawn from the off-site review and the exit meetings will focus on the examination findings.</p> <p>The assessors meetings with a number of AIs confirmed that the HKMA maintained a close contact with the institutions, at multiple levels within the organization. Senior level meetings with the Board (with and without executive management presence) and with the major committees such as the Audit and Risk Committee were routine practice. Firms commented that they found the HKMA to be accessible, thoughtful and reasonable.</p>
<p><b>EC8</b></p>	<p>The supervisor communicates to the bank the findings of its on- and off-site supervisory analyses in a timely manner by means of written reports or through discussions or meetings with the bank's management. The supervisor meets with the bank's senior management and the Board to discuss the results of supervisory examinations and the external audits, as appropriate. The supervisor also meets separately with the bank's independent Board members, as necessary.</p>
<p><b>Description and findings re EC8</b></p>	<p>As noted in EC7 above (and set out in SPM SA-1), the HKMA will normally hold prudential meetings with the senior management of every AI at least once a year following a comprehensive annual off-site review or a regular on-site examination. The HKMA also holds tripartite meetings with AIs and their external auditors to discuss external audit results (SPM SA-1). It should also be noted that the HKMA aims for active dialogue during the SRP of an AI, and on completion, communication of SRP results to the AI, including any areas of concern which may lead to an increase in its minimum CAR (see SPM CA-G-5).</p> <p>Please see EC 7 with respect to details on the HKMA's communication with the board and senior management of AIs.</p> <p><i>On-site examination</i> An on-site exit meeting is held with AIs' management to discuss preliminary results, followed by a written examination report with detailed findings and recommendations. AIs are requested to provide management response to the examination report within one month detailing the actions that they will undertake.</p> <p><i>Off-site review</i> A prudential meeting with senior management will be held to discuss areas of concern identified in the off-site review. A letter summarizing the key issues discussed in the meeting will be sent to the AI for record and follow-up actions.</p> <p>The HKMA does not often arrange separate meetings with the independent board members. This is largely because the majority of members of Audit Committees and Risk Committees of local banks are independent board members, (SPM CG-1). This</p>

	said, the HKMA would request a meeting with independent board members whenever it considers such a meeting necessary. Such meetings have been convened with independent board members in the past two years.
<b>EC9</b>	The supervisor undertakes appropriate and timely follow-up to check that banks have addressed supervisory concerns or implemented requirements communicated to them. This includes early escalation to the appropriate level of the supervisory authority and to the bank's Board if action points are not addressed in an adequate or timely manner.
<b>Description and findings re EC9</b>	<p>The HKMA has established internal standards and procedures to ensure that monitoring and follow up of issues and actions with firms takes place on a timely basis. All supervisory issues and findings relating to, and recommendations made to the AIs are documented for ongoing monitoring. The scope of monitoring includes (i) whether the AIs are able to implement necessary measures within the agreed timetable; (ii) whether the measures implemented / actions taken are adequate and effective.</p> <p>The HKMA has internal standards requiring banking supervision case officers to report ongoing monitoring work, including any exceptions or failure to implement remedial measures to supervisors on a quarterly basis. The Senior Manager and/or the Division Head will discuss with the bank for further rectification.</p> <p>If considered appropriate, the HKMA requires a bank to draw its Board's attention to the HKMA's on-site examination reports. Where action points are not addressed in an adequate or timely manner by the bank, the HKMA will then meet with the full Board, audit committee or risk management committee to bring the issue to their attention. While unusual, the HKMA has occasionally found the need to do this and found it to be effective in achieving the desired supervisory outcome.</p>
<b>EC10</b>	The supervisor requires banks to notify it in advance of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.
<b>Description and findings re EC10</b>	<p>There are a range of notification requirements that the AI must meet, set out in the BO and the SPM. Notifications required under the BO include, but are not limited to: alteration to its constitutional documents; ceasing to carry on the business of taking deposits or banking; inability to meet its obligations or when the AI is about to suspend payment; sale / disposal of all or any part of its banking business; change of specified persons (including controllers and directors (of locally incorporated AIs) and chief executive (for all AIs)); and breach of minimum capital adequacy requirements. Furthermore, AIs must submit a quarterly return to certify compliance with the relevant sections of the BO.</p> <p>In addition to the above statutory notification requirements, there are notification requirements set out in the SPM. This includes requirements to notify the HKMA immediately of any breach of the statutory large exposures and risk concentration limits or, in relation to Operational Risk, of any event(s) that may have a significant impact on their operations.</p> <p>The HKMA has also issued a circular letter on incident response and management</p>

	<p>procedures (2010) to reinforce to AIs their responsibility to notify the HKMA as soon as they are aware of the occurrence of a significant incident (e.g., disruption of any essential and critical banking service channel which affects a substantial number of customers).</p> <p>Nevertheless, given that this range of notification requirements might not be fully comprehensive, encompassing the notification of a material adverse development in all circumstances, the HKMA has therefore issued, (October 2013) a circular ensuring that this requirement was imposed with immediate effect.</p>
<b>EC11</b>	The supervisor may make use of independent third parties, such as auditors, provided there is a clear and detailed mandate for the work. However, the supervisor cannot outsource its prudential responsibilities to third parties. When using third parties, the supervisor assesses whether the output can be relied upon to the degree intended and takes into consideration the biases that may influence third parties.
<b>Description and findings re EC11</b>	The HKMA does not outsource its prudential responsibilities including off-site review and on-site examination of AIs to outside third parties. However, under specific circumstances (e.g., where weaknesses are identified in specific areas relating to the systems and controls of an AI) the HKMA makes use of powers under BO section 59 to require the external auditors of the AI to submit a report to the MA on a specified scope of review – the accuracy of prudential returns or adequacy of an aspect of internal controls might fall within this scope. The HKMA would use the report as a reference document for its prudential supervision. The HKMA is mindful of the need to assess the extent to which reliance can be placed on such reports and has the power, if needed, under section 59 of the BO to require that a report be obtained from another firm of auditors than the external auditors of the AI concerned.
<b>EC12</b>	The supervisor has an adequate information system which facilitates the processing, monitoring and analysis of prudential information. The system aids the identification of areas requiring follow-up action.
<b>Description and findings re EC12</b>	<p>The Enhanced Prudential Supervision System (EPSS), stores the prudential data on all AIs, enabling the HKMA to interrogate, compare and analyze banking return data of AIs from time to time. The EPSS enables the HKMA to generate high-level MIS reports on assets and liabilities, profitability and asset quality and various other financial indicators as well as stress-testing reports based on various stress scenarios to facilitate trend monitoring, identification of outliers. The system can also generate various MIS reports on key banking return information either as needed upon request. Case teams automatically receive reports that will highlight any major changes in supervisory data and alerts of any breach of a supervisory requirement or ratio.</p> <p>A project to revamp the HKMA's EPSS was initiated in 2011. While the underlying database remains fit for purpose, the interface was not considered to be user friendly and the intent is to enhance the ability to interrogate and manipulate the data.</p>
<b>Additional criteria</b>	
<b>AC1</b>	The supervisor has a framework for periodic independent review, for example by an internal audit function or third party assessor, of the adequacy and effectiveness of the range of its available supervisory tools and their use, and makes changes as appropriate.
<b>Description and</b>	The Internal Audit Division (IAD) of the HKMA prepares an annual work plan using a

<b>findings re AC1</b>	<p>risk-rated planning framework covering all the functions of the entire HKMA. This methodology has been endorsed by the senior management of the HKMA and the Audit-Sub Committee (ASC) of the Exchange Fund Advisory Committee. With this methodology, the IAD prepares an annual audit plan for approval by the ASC in November of the preceding year. The normal audit cycle is three years, meaning that each function will be audited at least once every three years. All Banking Departments are covered in this audit planning framework.</p> <p>The IAD carries out audits according to the approved audit work plan. The internal audit engagement is designed to assess the existence, adequacy and effectiveness of internal control system. Following each review, an audit report on the existence, quality and adequacy of internal control systems, where appropriate, will be issued to line management with recommendations for consideration of their implementation.</p> <p>The IAD examined the work of the Banking Supervision Department in 2012/2013. The main findings concerned the sampling methods adopted by on-site examination teams in transactional review of AI's operations, adequacy of documentation/audit trail of work performed in on-site examinations, insufficient reliance on pre-set examination guidelines in conducting on-site examinations, timeliness in updating internal procedures in the off-site review process. Each division subject to the internal audit set up action plans and timetable to address the findings.</p> <p>The assessors were able to review some reports from the IAD and found them to be clear, thorough and procedures have been put in place to act on the findings.</p> <p>The HKMA is also conscious of the need to reflect periodically on the structure and efficacy of its arrangements. This is demonstrated not least by the reorganizations to the department following the crisis (e.g., separating conduct and supervision activities) and the commissioning of an external consultant to advise on its existing arrangements.</p>
<b>Assessment of Principle 9</b>	Compliant
<b>Comments</b>	<p>The HKMA conducts a well balanced supervisory approach, with an emphasis on preventative approaches, carefully integrating on and off-site surveillance techniques. Supervisory teams and specialists demonstrate a close knowledge of and insight into individual banks and of the system wide dimensions. The annual risk assessment process enables the HKMA to adjust its supervisory priorities and as necessary its resources.</p> <p>The HKMA sets and communicates clear expectations to the industry and balances a readiness to challenge banks' practices with an openness to and understanding of banks' legitimate business concerns.</p> <p>Commendably, the HKMA is aware of the need to maintain the highest standards of supervisory practice and that this implies both evolution and consistency of practice over time. The review of banking supervisory processes and subsequent initiation of a quality assurance framework reflects this awareness. It is important for momentum to be maintained in this field not least in order to ensure the technical independence of</p>

	<p>the supervisory work against any potential undue pressures, It is paramount that the supervisory processes are clearly defined and their integrity well preserved and the new framework will support this.</p> <p>One area where it is recommended that the HKMA should pay close attention is the frequency of on-site review of AIs which are incorporated overseas, i.e., the foreign branches in Hong Kong. Similarly, the HKMA should consider a review and as necessary a revision of internal guidance relating to the supervision of foreign branches in Hong Kong. While it is clear that the HKMA pays close attention to branches when the activities are more integrated into Hong Kong, and may in such cases encourage subsidiarization, the open nature of Hong Kong markets attracts very many foreign branches which, collectively, may represent common risks that need to be addressed.</p>
<b>Principle 10</b>	Supervisory reporting. The supervisor collects, reviews and analyses prudential reports and statistical returns <sup>25</sup> from banks on both a solo and a consolidated basis, and independently verifies these reports through either on-site examinations or use of external experts.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor has the power <sup>26</sup> to require banks to submit information, on both a solo and a consolidated basis, on their financial condition, performance, and risks, on demand and at regular intervals. These reports provide information such as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, risk concentrations (including by economic sector, geography and currency), asset quality, loan loss provisioning, related party transactions, interest rate risk, and market risk.
<b>Description and findings re EC1</b>	<p>The MA has the power to impose prudential standards on both solo and consolidated bases. BO section 63 gives the MA powers to collect prudential data on both a regular and ad-hoc basis, and such power extends to any holding company of an AI, any subsidiary of any such holding company, and any subsidiary of an AI under BO section 63(2A). Specific requirements relating to capital, liquidity and concentration/large exposure risks are set out in the BO. Consolidated data on capital, liquidity and large exposures is required from AIs with subsidiaries.</p> <p>The HKMA also, from time to time, requires AIs to provide non-routine data, which may include information on their holding companies. In general, the approval granted to the non-bank holding company of a locally incorporated AI to become the AI's shareholder controller has had certain reporting requirements on the holding company's capital or financial positions attached to it.</p> <p>A locally incorporated AI may be required to report relevant returns up to four separate levels</p>

<sup>25</sup> In the context of this Principle, "prudential reports and statistical returns" are distinct from and in addition to required accounting reports. The former are addressed by this Principle, and the latter are addressed in Principle 27.

<sup>26</sup> Please refer to Principle 2.

	<ul style="list-style-type: none"> <li>• AI's local offices and branches;</li> <li>• AI's overseas branches in each country;</li> <li>• combined position of the AI's local and overseas branches; and</li> <li>• consolidated position of the banking group including subsidiaries.</li> </ul> <p>Failure of an AI, without reasonable excuse, to comply with certain requirements in BO section 63 is an offence which may result in fines and imprisonment (see BO section 63(5) and (6)).</p> <p>BO section 64 empowers the MA to collect information on a company in which an AI has a beneficial ownership of an aggregate of 20 percent or more of the share capital or where any director or manager or controller of that company is also a director, chief executive or manager or controller of an AI.</p> <p>The HKMA requires a comprehensive set of prudential returns to be submitted on a regular basis. This includes, though not limited to, balance sheet, liquidity, renminbi, HK dollar interbank transactions and foreign exchange positions on a monthly basis, capital, P&amp;L, large exposures and asset quality quarterly, and other activities such as insurance or securities related half-yearly.</p>
<b>EC2</b>	The supervisor provides reporting instructions that clearly describe the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that are widely accepted internationally.
<b>Description and findings re EC2</b>	<p>The returns noted in EC1 are supplied with detailed completion instructions which were drawn up taking into consideration the accounting principles and standards applicable to AIs incorporated in Hong Kong, which are the Hong Kong Financial Reporting Standards. These standards are in line with the International Accounting Standards.</p> <p>These instructions are subject to periodic review to ensure that, among other things, their relevance is not affected by changes in accounting standards. The HKMA may also issue circular letters to clarify the reporting basis of certain return items where necessary.</p> <p>The HKMA also keeps abreast of accounting developments in Hong Kong and internationally. It arranges periodic meetings with the HKICPA to discuss issues of mutual interest to both organizations and revises supervisory reporting requirements so that they are in line with the accounting standards as appropriate.</p>
<b>EC3</b>	The supervisor requires banks to have sound governance structures and control processes for methodologies that produce valuations. The measurement of fair values maximizes the use of relevant and reliable inputs and are consistently applied for risk management and reporting purposes. The valuation framework and control procedures are subject to adequate independent validation and verification, either internally or by an external expert. The supervisor assesses whether the valuation used for regulatory purposes is reliable and prudent. Where the supervisor determines that valuations are not sufficiently prudent, the supervisor requires the bank to make adjustments to its reporting for capital adequacy or regulatory reporting purposes.
<b>Description and</b>	Clear expectations in respect to valuation frameworks and procedures are set out in



<p><b>findings re EC3</b></p>	<p>the Banking Capital Rules (BCR), SPM and based on minimum authorization criteria under BO Schedule 7 which require every AI to:</p> <ul style="list-style-type: none"> <li>• maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur; and</li> <li>• have adequate accounting systems and adequate systems of control.</li> </ul> <p>The BCR (section 4A(1)) requires AIs to establish and maintain valuation systems, controls and procedures that are effective to ensure that the valuation of the AIs' exposures for capital adequacy purposes is prudent and reliable. BCR section 4A(2) further requires AIs to make valuation adjustments to account for model limitations, liquidity and other relevant factors that might affect the prudence and reliability of the valuation.</p> <p>The SPM CA-G-5 Supervisory Review Process Annex C, Template B1 includes the adequacy and effectiveness of fair valuation practices among the risk management factors that need to be assessed in the context of assessing capital adequacy under the Supervisory Review Process (SRP). Guidance on valuation is included in SPM CA-S-10 Financial Instrument Fair Value Practices.</p> <p>The SPM (IC-1 General Risk Management Controls ) specifies the general controls the MA expects AIs to have in place in their risk management system as well as the factors an AI should consider, which include the assumptions of the models chosen (including associated valuation and pricing methodology) and data availability.</p> <p>For risk measurement purposes, AIs should be able to value their positions based on sound valuation practices. For exposures that represent material risk, AIs should have the capacity to produce valuations using alternative methods in the event that primary inputs and approaches become unreliable, unavailable or not relevant due to market disruptions or illiquidity (SPM IC-1).</p> <p>The HKMA's expectations on AIs' governance, controls and risk management systems for the valuation of financial instruments measured at fair value are also set out in the SPM CA-S-10.</p> <p><i>On and off-site examination</i></p> <p>The HKMA's off-site assessment processes include:</p> <ul style="list-style-type: none"> <li>• reviewing the financial statements / disclosures which contain information about AIs' policies, processes and control frameworks for valuation (i.e., for consistency and conformity with the AI's declared policies);</li> <li>• reviewing the external auditors' reports on financial statements, the management letters issued by the external auditors, and external auditors' reports commissioned under BO, including those under section 63(3) and section 63(3A) of the BO (see EC 9 below) to see if there is any adverse opinion made or issues identified by the external auditors; and</li> <li>• discussing issues related to AIs' valuation methodology, practices and the</li> </ul>
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	<p>relevant controls (e.g., verification and validation) at tripartite meetings with the AIs and their external auditors.</p> <p>If potential issues of concern are identified, the HKMA will review an AI's valuation policies and methods in an on-site examination. Instances where valuation policies, practices and procedures are subject to more specialized review in on-site examinations include:</p> <ul style="list-style-type: none"> <li>• review of treasury and derivatives activities,</li> <li>• during on-site examinations of AIs' implementation of internal model approach, -again the on-site team assesses compliance with SPM CA-S-10.</li> </ul> <p>Where necessary, the HKMA may require an AI to make adjustments to fair values of financial instruments in the measurement of capital adequacy. In some situations, if the HKMA considers a more prudent approach is warranted to ensure that a buffer exists to cushion possible valuation adjustments, it may take the supervisory actions as it considers appropriate. Such supervisory actions may include (1) imposing a regulatory reserve; and (2) requiring the AI to hold additional capital above its existing minimum capital requirement.</p>
<b>EC4</b>	The supervisor collects and analyses information from banks at a frequency commensurate with the nature of the information requested, and the risk profile and systemic importance of the bank.
<b>Description and findings re EC4</b>	<p>There is a standard reporting frequency for each banking return or survey, which can be weekly, monthly, quarterly, half-yearly or annually depending on the type and nature of information to be collected.</p> <p>If the nature of activities, risk profile, etc. of a particular AI warrant closer monitoring, the HKMA may request for more frequent submission of more focused information (e.g., abridged balance sheet and liquidity ratios on a weekly basis).</p> <p>Selected AIs (because of their size or activities etc) can be required to report certain information on a more frequent basis, or to provide additional information on specific business activities (e.g., securities investment, taxi financing).</p> <p>The HKMA also regularly (monthly) receives AIs' MIS packages, partly to assess the quality of internal information and to ensure consistency with the prudential information that is formally submitted.</p>
<b>EC5</b>	In order to make meaningful comparisons between banks and banking groups, the supervisor collects data from all banks and all relevant entities covered by consolidated supervision on a comparable basis and related to the same dates (stock data) and periods (flow data).
<b>Description and findings re EC5</b>	<p>Regular prudential data are collected through returns and also surveys which are normally submitted on a monthly or quarterly basis. However, the frequency of submission can be changed subject to need.</p> <p>Each statistical banking return has a standard format and collects data for the same period or at the same position date. This ensures that the solo returns of an AI, the returns of its subsidiaries which are AIs (if any) and the consolidated returns of the AI</p>

	<p>are reported on a comparable basis. The HKMA uses data collected from AIs for compiling industry-wide MIS reports or performing peer group comparisons.</p> <p>When designing new returns or surveys, the reporting period or reporting date of the new returns or surveys are synchronized with the existing returns or surveys where appropriate to facilitate comparability.</p> <p>The surveys themselves are a form of regular reporting and can sometimes be an interim step before formal returns are required. They are a flexible tool and can be used for ad hoc data generation (e.g., the HKMA can distribute an email request to all relevant AIs) but a number, such as that on residential mortgage lending, are regular and long standing.</p>
<b>EC6</b>	<p>The supervisor has the power to request and receive any relevant information from banks, as well as any entities in the wider group, irrespective of their activities, where the supervisor believes that it is material to the condition of the bank or banking group, or to the assessment of the risks of the bank or banking group or is needed to support resolution planning. This includes internal management information.</p>
<b>Description and findings re EC6</b>	<p>The MA has strong powers to obtain information under the BO which, for example, under BO section 63(2) require an AI to submit (including on a periodic basis) such further information as he may reasonably require (this could include internal management information) for the exercise of his functions under the BO and in such manner as he may require. Also, the MA is empowered under BO section 63(2A) to require the AI's holding company, the holding company's subsidiaries and the AI's subsidiaries to submit such information.</p> <p>Also, as noted above under CP8 EC6, the information gathering powers under BO section 63 enable the MA to gather information relevant for purposes of resolvability assessment and RRP. As noted in EC4 of this CP, the HKMA receives AIs' MIS packages.</p> <p>In practice, when an AI is part of a large group conducting diverse activities, the HKMA requests financial accounts and other information relating to the AI's major group companies, through making its request to the local AI or its parent company.</p>
<b>EC7</b>	<p>The supervisor has the power to access<sup>27</sup> all bank records for the furtherance of supervisory work. The supervisor also has similar access to the bank's Board, management and staff, when required.</p>
<b>Description and findings re EC7</b>	<p>The MA has strong information gathering powers under the BO (particularly sections 55, 56, 63 and 72A) as well as under other Ordinances.</p> <p>Under BO section 55(1), the MA may at any time, with or without prior notice to an AI, examine its books, accounts and transactions. BO section 56(1) provides that for the purposes of section 55(1), an AI shall afford the examiners access to its books and accounts, to documents of title to its assets and other documents, to all securities held by it in respect of its customers' transactions and its cash and to such other</p>

<sup>27</sup> Please refer to Principle 1, Essential Criterion 5.

	<p>information and facilities as may be required for the examination or investigation.</p> <p>In the case of an AI incorporated in Hong Kong, the abovementioned powers are extended to any local branch, local office, overseas branch, overseas representative office and subsidiary (whether in or outside Hong Kong) of the AI.</p> <p>As mentioned in EC1, the MA may also under BO section 63(2) require an AI to submit (including periodically submit) such further information as he may reasonably require for the exercise of his functions under the BO and in such manner as he may require.</p> <p>Under BO sections 56(2) and 63(6), every director, chief executive and manager of an AI which, without reasonable excuse, contravenes, respectively, section 56(1) or section 63(2) commits an offence and is liable to a fine and imprisonment upon conviction.</p> <p>The powers under the BO enable the HKMA to require AIs to make any member of staff available for prudential or other meetings if the MA believes that the person has information relevant to the exercise of the MA's functions.</p> <p>However, where the person is a "specified person" as defined in BO section 72A(1) (which includes an AI's chief executive, the directors and controllers of locally incorporated AIs, and "executive officers" and "relevant individuals" of AIs doing securities business) the MA may impose a direct requirement on such person to submit such information as the MA may reasonably require for the exercise of his functions under the BO and such information shall be submitted in such manner as the MA may require. Failure to comply with such a request constitutes an offence and may call into question the fitness and propriety of the individual, which may result in the withdrawal of the MA's consent under the BO for the individual to fulfill his/her position. Furthermore, under the MPFSO, SFO and AMLO, the MA has specific powers to require certain persons to produce documents and attend at a specified place and time to answer questions, apart from the information gathering powers on the AIs.</p> <p>The HKMA has not encountered any difficulties in accessing AIs' records, Board, management and staff when required.</p>
<b>EC8</b>	<p>The supervisor has a means of enforcing compliance with the requirement that the information be submitted on a timely and accurate basis. The supervisor determines the appropriate level of the bank's senior management is responsible for the accuracy of supervisory returns, imposes sanctions for misreporting and persistent errors, and requires that inaccurate information be amended.</p>
<b>Description and findings re EC8</b>	<p>To ensure the accuracy of the data submitted, the banking returns have to be signed off by the chief executive and the chief accountant or their delegates. Additionally the certificate of compliance (see CP8) exerts a strong discipline on management to ensure accuracy of prudential data that is submitted.</p> <p>The BO establishes (sections 63(5) and (6)) that failure to provide information as required under the BO constitutes an offence on the part of the individual, whether director, chief executive or manager. The individual will be liable to fine and imprisonment. The provision is widely drawn and does not apply solely to individuals</p>

	within the AI but also holding company of an AI, subsidiary of such holding company or subsidiary of an AI. Similarly, (under BO section 63(7)), any person who signs any document which he knows or reasonably ought to know to be false in a material particular commits an offence and is liable to a fine and imprisonment.
<b>EC9</b>	The supervisor utilizes policies and procedures to determine the validity and integrity of supervisory information. This includes a program for the periodic verification of supervisory returns by means either of the supervisor's own staff or of external experts. <sup>28</sup>
<b>Description and findings re EC9</b>	<p>The MA is empowered under the BO to require an AI to submit a report prepared by an auditor or auditors appointed by the AI as to:</p> <ul style="list-style-type: none"> <li>• whether a return or information submitted by the AI is correctly compiled, in all material aspects, from the books and records of the AI and, if not so correctly compiled, the nature and extent of the incorrectness (section 63(3));</li> <li>• whether the AI has in place systems of control adequate to enable returns or information to be correctly compiled, in all material respects, from its books and records (section 63(3A)(a)(i));</li> <li>• whether the AI complies with its duties under the BO Parts XII, XV, XVII and XVIII (section 63(3A)(a)(ii));</li> <li>• if the AI is incorporated in Hong Kong, whether the AI maintains adequate provision for depreciation or diminution in the value of assets (section 63(3A)(a)(iii)).</li> </ul> <p>The detailed requirements and arrangements for the BO section 63 reports are set out in the SPM IC-3 Reporting Requirements Relating to Authorized Institutions' External Auditors under the BO. SPM IC-3 section 1.3.3 sets out the external auditors' major duties and responsibilities in relation to prudential supervision under the BO.</p> <p>The electronic banking return templates have built-in validation systems to facilitate the checking of consistency and accuracy of data inputs by AIs. All returns received are subject to an independent validation by the Enhanced Prudential Supervision System ( EPSS ), a system storing prudential information of all AIs, after which the returns will be available for review by the supervision teams within the HKMA.</p> <p>Variance exception reports and contravention reports are issued to the supervision teams within the HKMA for follow-up actions.</p> <p>If reporting errors are uncovered, AIs are required to submit amended returns to rectify the errors identified. In the course of reviewing the banking returns submitted by AIs, the HKMA staff also assesses the reasonableness and consistency of the data reported based on the trend of historical data reported by the AIs and the HKMA's understanding of the AIs' risk profiles and business activities.</p>

<sup>28</sup> May be external auditors or other qualified external parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions.

<b>EC10</b>	The supervisor clearly defines and documents the roles and responsibilities of external experts, <sup>29</sup> including the scope of the work, when they are appointed to conduct supervisory tasks. The supervisor assesses the suitability of experts for the designated task(s) and the quality of the work and takes into consideration conflicts of interest that could influence the output/recommendations by external experts. External experts may be utilized for routine validation or to examine specific aspects of banks' operations.
<b>Description and findings re EC10</b>	<p>The MA is empowered under the BO to require AIs to submit reports prepared by external auditors for the following purposes:</p> <ul style="list-style-type: none"> <li>• opining as to the correct compilation of banking returns under section 63(3);</li> <li>• opining as to whether an AI's systems of control are adequate to enable, as much as practicable, the AI's returns to be correctly compiled, in all material respects, from the AI's books and records under section 63(3A)(a)(i); and</li> <li>• reporting on specific areas of the internal control systems of AIs (e.g., adequacy of high level controls) under section 59(2).</li> </ul> <p>AIs are required to commission auditor reports under BO sections 63(3) and 63(3A) normally once a year. Reports are commissioned under section 59(2) if the HKMA considers it is necessary.</p> <p>The HKMA must approve the auditors who are to be used in respect of reports commissioned under sections 63(3), 63(3A) or 59(2) of the BO. The roles and responsibilities of external auditors in relation to the above tasks are set out in the SPM (IC-3 Reporting Requirements Relating to Authorized Institutions' External Auditors under the BO section 1.3.3). The HKMA's requirements / expectations regarding the appointment, removal and resignation of external auditors for the conduct of the above-mentioned tasks are set out in the SPM (IC-3 section 2).</p> <p>When an AI is required to submit an external auditors' report under BO section 59(2), the HKMA will formulate the terms of reference (with feedback sought from the AI's management), which specify in detail the objectives, scope of review, period to be covered and due date for submission that the external auditors should observe in planning and conducting the review. The MA then formally writes to the AI with the agreed terms of reference enclosed.</p> <p>The auditors appointed for the various purposes under the BO, as mentioned above (except for BO section 59(2)) will normally be an AI's existing auditors. The HKMA has indicated however that it may commission reports from another firm of auditors where:</p> <ul style="list-style-type: none"> <li>• the HKMA considers that this arrangement can better utilize the knowledge and expertise of different auditors which may be beneficial to the AI; or</li> </ul>

<sup>29</sup> May be external auditors or other qualified external parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions. External experts may conduct reviews used by the supervisor, yet it is ultimately the supervisor that must be satisfied with the results of the reviews conducted by such external experts.

	<ul style="list-style-type: none"> <li>• he has reason to believe that the existing auditors would not be capable of producing an adequate report. In reaching this judgment, he will take into account: <ul style="list-style-type: none"> <li>- the reputation of the existing auditors;</li> <li>- the quality of the reports previously submitted to him;</li> <li>- the expertise, knowledge and resources of the existing auditors; and</li> <li>- any potential conflict of interest on the part of the existing auditors.</li> </ul> </li> </ul> <p>Even where there are no doubts about the capability of the existing auditors, the HKMA may require that a report under BO section 59(2) should be obtained from another firm of auditors. This would be to obtain a fresh and independent perspective on the matters which are the subject of the review.</p> <p>If the HKMA does not intend to approve the existing auditors under BO section 59 or 63, it is normal practice to first consult the AI concerned. Usually the HKMA will request the AI to propose another firm of auditors for his approval. If the AI fails to propose a satisfactory firm within a specified timeframe, the HKMA then nominates a selection of suitable firms from which the AI will be required to choose.</p>
<b>EC11</b>	The supervisor requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes.
<b>Description and findings re EC11</b>	<p>Under BO sections 63A and 63B, the external auditor of an AI is required to report to the MA any matter of which he becomes aware, in the course of performing his duties in relation to BO sections 59(2), 63(3) or 63(3A) or CO section 131, which adversely affects the financial position of the AI to a material extent or constitutes a failure to comply with any prescribed requirements within the meaning of SFO section 157 (auditors of licensed corporations or associated entities of intermediaries to lodge report with the SFC, etc in certain cases).</p> <p>BO section 61 stipulates that the external auditor of an AI who communicates in good faith to the MA, whether or not on his own initiative, any information or opinion on a matter of which he becomes aware and which is relevant to any function of the MA under the BO will not be regarded as having contravened any duty to which he may be subject.</p> <p>Under SPM IC-3 Reporting Requirements Relating to Authorized Institutions' External Auditors under the BO, the external auditor of an AI should consider making a report directly to the MA in respect of any matter (other than those already required to be reported under BO sections 63A and 63B) where he considers that depositors' interests might be better protected if the MA was made aware of it.</p>
<b>EC12</b>	The supervisor has a process in place to periodically review the information collected to determine that it satisfies a supervisory need.
<b>Description and findings re EC12</b>	The HKMA assesses, using a number of data sources including the supervisory data collected and developments in macro conditions, whether additional data requirements should be made in order to enable the HKMA to carry out its statutory functions and responsibilities.

	<p>The data requirements on AIs are reviewed in light of changes in macro conditions. For example, the residential mortgage survey is reviewed and updated to reflect AIs' compliance with the latest prudential measures on property market lending and supervisory need for information on the property mortgage loans granted by AIs.</p> <p>In addition, following the implementation of legislative changes (e.g., changes of the Banking (Capital) Rules as a result of the introduction of the Basel 3 capital requirements), banking returns will be reviewed and amended to ensure that the data to be collected enable the Banking Supervision Department to carry out the analysis necessary for the performance of its supervisory functions.</p> <p>Where the data collected are no longer considered necessary, request for submission of the return / survey would discontinue e.g., the weekly deposit survey and the monthly survey on "one-stop" service for renminbi account opening. Similarly, the HKMA may collect additional information from AIs as it considers appropriate (e.g., the introduction of a new Return on Mainland activities in September 2013 to require relevant AIs to report more detailed information on their non-bank Mainland exposures).</p>
<b>Assessment re Principle 10</b>	Compliant
<b>Comments</b>	<p>The HKMA has wide powers of information gathering which it uses effectively. The authority receives standard prudential data from firms as well as much management information and supplementary data from surveys and ad hoc data as necessary. The HKMA is alert to the potential of seeking redundant information and reviews the necessity of its information requests periodically. Equally, when new returns are required (such as the new return with respect to exposures to Mainland China) considerable care is taken in identifying comprehensive and granular data points to be reported in order to facilitate thorough analysis.</p> <p>The annual discipline of commissioning reports on the accuracy of returns and the potential to commission reports when needed from the external auditor on the underlying control systems for the preparation of information that is submitted to the HKMA provides a further level of control.</p>
<b>Principle 11</b>	Corrective and sanctioning powers of supervisors. The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability to revoke the banking license or to recommend its revocation.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor raises supervisory concerns with the bank's management or, where appropriate, the bank's Board, at an early stage, and requires that these concerns be addressed in a timely manner. Where the supervisor requires the bank to take significant corrective actions, these are addressed in a written document to the bank's Board. The supervisor requires the bank to submit regular written progress reports and checks that corrective actions are completed satisfactorily. The supervisor follows through conclusively and in a timely manner on matters that are identified.
<b>Description and</b>	As a general supervisory approach, the HKMA will discuss matters of supervisory



<p><b>findings re EC1</b></p>	<p>concern with the AI's senior management promptly and will require the senior management to address the issues in a timely manner and also to follow up the concern in writing. In the case of on-site examinations, the HKMA will issue a report to the senior management of the AI setting out the findings of, and recommendations arising from, an on-site examination. The AI is required to provide a written response, within a reasonable time (normally within 30 days), on the measures it will introduce to address the supervisory concerns and the time plan for implementation.</p> <p>If the supervisory issues are significant, urgent or indicate weaknesses in corporate governance the HKMA will communicate directly with the Board, in line with the requirement specified in SPM CG-1 (Corporate Governance of Locally Incorporated Authorized Institutions). The HKMA will either meet directly with the Board or a Board-level committee or submit the HKMA's letter or examination report to the AI for the Board's attention and its appropriate action.</p> <p>To ensure appropriate follow-up action, the HKMA reviews the AI's response and requires reports on implementation progress including relevant supporting information. It is the HKMA's practice to verify the effectiveness of the remedial measures through its own on-site examination or through requiring the AI to commission external auditors to conduct verification pursuant to BO section 59(2) (please see SPM IC-3). The assessors noted HKMA management reports that indicated the attention paid to follow-up actions.</p> <p>In terms of legal and regulatory underpinning for the HKMA's approach, the BO sets out processes and procedures in relation to remedial and corrective actions in relation to failures to maintain specified levels of capital or liquidity. Other supervisory interaction for securing remedial measures, whilst not specifically laid out in the BO, takes place within the purposive framework created by the BO.</p> <p><i>Power to determine corrective actions in cases of breach of capital / liquidity requirements</i></p> <p>Under BO section 97E(1), if an AI contravenes capital requirements prescribed under section 97C, the AI and the MA must enter into discussions to determine necessary remedial actions, but the MA is not bound by any such discussions. After holding such discussions the MA may, under BO section 97E(2), by notice in writing served on the AI, require it to take the remedial actions specified in the notice. Similar provision under BO section 104 applies for contraventions of liquidity requirements under BO section 102(1).</p> <p>The MA exercises a variety of supervisory powers predicated upon the requirement for AIs to comply with the ongoing authorization criteria in BO Schedule 7 and supported by the MA's broad supervisory intervention powers under BO section 52 (even though use of section 52 is rare). Where, however, powers under BO section 52(1)(A) are exercised to direct an AI to take specific actions or to impose restrictions on its business, the MA must serve a written notice. This notice will generally specify the timeframe for taking the required actions or complying with the imposed restrictions.</p> <p>Where the MA proposes to exercise certain powers under the BO to impose sanctions</p>
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	<p>in cases of noncompliance with corrective actions, those powers generally provide a timeframe for the MA to give notice of the proposed actions to the AI or person concerned and for the AI or person to make representations (e.g., BO section 71(4)).</p> <p>The MA can make use of general information collection powers under BO section 63(2) to require an AI to submit regular written progress reports.</p> <p><i>General provision on timeliness of required actions</i></p> <p>In cases where no time limit is specified under the BO, the Interpretation and General Clauses Ordinance section 70 applies. This Ordinance contains a general provision relating to the construction, application and interpretation of law providing that where no time is prescribed or allowed within which anything shall be done, such thing shall be done without unreasonable delay, and as often as due occasion arises.</p>
<b>EC2</b>	<p>The supervisor has available<sup>30</sup> an appropriate range of supervisory tools for use when, in the supervisor's judgment, a bank is not complying with laws, regulations or supervisory actions, is engaged in unsafe or unsound practices or in activities that could pose risks to the bank or the banking system, or when the interests of depositors are otherwise threatened.</p>
<b>Description and findings re EC2</b>	<p>The BO provides the MA with a range of supervisory powers. The BO provides the legal basis for the MA not only to supervise AIs from a prudential perspective but also to enforce regulatory compliance by taking enforcement action where necessary (see also CP1, EC1). In addition, the MA has inspection and investigation powers under the AMLO and MPFSO and disciplinary powers under the AMLO.</p> <p>Under BO section 52, the MA, following consultation with the FS, may:</p> <ul style="list-style-type: none"> <li>• require the AI to forthwith take any action or to do any act or thing whatsoever in relation to its affairs, business and property as he may consider necessary (e.g., suspend certain businesses) (section 52(1)(A));</li> <li>• appoint an Advisor to advise the AI on the management of its affairs, business and property as he may specify (section 52(1)(B));</li> <li>• appoint a Manager to manage such of the AI's affairs, business and property as he may specify (section 52(1)(C)); or</li> <li>• subject to section 52(2), report the circumstances to the Chief Executive in Council under section 52(1)(D) who may direct the FS to present a petition to the Court of First Instance for winding up the AI under section 53(1).</li> </ul> <p>The circumstances under which these powers can be used are if:</p> <ol style="list-style-type: none"> <li>(a) an AI informs the MA that it is likely to become unable to meet its obligations or that it is insolvent or about to suspend payment;</li> <li>(b) an AI becomes unable to meet its obligations or suspends payment;</li> <li>(c) the MA is of the opinion that:       <ol style="list-style-type: none"> <li>(i) an AI is carrying on its business in a manner detrimental to the interests of</li> </ol> </li> </ol>

<sup>30</sup> Please refer to Principle 1.

	<p>its depositors or potential depositors, its creditors, or holders or potential holders of multi-purpose cards issued by it or the issue of which is facilitated by it;</p> <ul style="list-style-type: none"> <li>(ii) an AI is insolvent or is likely to become unable to meet its obligations or is about to suspend payment;</li> <li>(iii) an AI has contravened or failed to comply with any provisions of the BO;</li> <li>(iv) an AI has contravened or failed to comply with any condition attached to its authorization or approval or specified in certain provisions in the BO (e.g., under section 49(1) of the BO, all AIs incorporated in Hong Kong require the MA's approval before they establish an overseas branch); or</li> <li>(v) his power under BO section 22(1) to propose to revoke the authorization of an AI is exercisable; or</li> </ul> <p>(d) the FS advises the MA that he considers it in the public interest to do so.</p> <p><i>Conditions attached to authorization</i></p> <p>Under the BO, section 16(5), the MA may attach conditions to the authorization of an AI. These conditions may, for example, impose restrictions, either generally or in any particular case, on the banking business or business of taking deposits which may be carried on by the AI (see section 16(9)(a)).</p> <p><i>Revocation or suspension</i></p> <p>Under the BO sections 22, 24 and 25, the MA may, after consultation with the FS, propose to revoke (section 22) or suspend (section 24 or section 25) the authorization of an AI based on any one or more of the grounds specified in the BO Schedule 8 (including the failure to continue to meet any of the minimum authorization criteria specified in the BO Schedule 7). The grounds for revocation or suspension include an AI violating prudential requirements (such as minimum capital or liquidity ratios), providing materially false, misleading or inaccurate information to the MA or carrying on its business in a manner that is, in the MA's opinion, detrimental to the interests of its depositors.</p> <p><i>Penal provisions</i></p> <p>The BO contains penal provisions in relation to a number of prudential requirements (e.g., on large exposures and concentration limits, capital requirements, and liquidity etc.). These provisions stipulate that a breach by the AI of these requirements or the failure of the AI to take remedial actions as specified by the MA is a criminal offence under which every director, chief executive and manager of the AI concerned is liable to fine and imprisonment.</p> <p>With respect to addressing the contravention of capital or liquidity requirements the MA may, after holding discussions with the AI, serve a notice on the AI requiring it to take remedial action specified in the notice (BO sections 97E(2), 104(2) (and 97J(2) when it comes into operation in relation to liquidity)). Failure of an AI to meet any requirements specified in a notice served requiring remedial actions following contravention of capital or liquidity requirements is an offence which will cause every director, chief executive and manager of the AI to be personally liable to fines and imprisonment (BO section 97E(4), 104(5) (and 97J(4) when it comes into operation)). In practice, the MA has rarely had to make use of such formal powers.</p>
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*(a) Imposition of supervisory measures*

The MA can exercise a range of supervisory intervention powers under the BO though in practice this is unusual, as AIs typically comply with the “supervisory requests” of the HKMA case teams. Examples of “agreed” remedial measures, where assessors saw relevant files, include:

- limiting expansion of business (e.g., expansion in certain lending activities or treasury activities) or restricting certain activities (e.g., taking of public deposits) given the significantly increasing risks posed to the AI and/or the unsatisfactory systems and internal controls of the AI
- resignation of members of AIs' senior management, following indications by the MA of reservations as to their fitness or propriety.
- provision by the parent bank of an overseas incorporated AI of a commitment letter to provide financial support to the AI given the banking group's transfer pricing policy and its potential effect on the capital adequacy of the AI
- reduction of leverage when the HKMA's stress testing results revealed that the capital position of an AI was more susceptible to credit risk given its high leverage and relatively thin profit margin.
- adoption of matched-term funding arrangements by selected foreign AIs which exhibited significant credit growth in 2011 coupled with structural reliance on short-term funding from the interbank market or their head office (i.e. these AIs must ensure that their loans for use in Hong Kong with a tenor of 1 year or longer are funded by net placements from the head office with a maturity of 1 year or more).

*(b) Downgrading of CAMEL rating and raising of statutory minimum CAR*

In respect of a specific AI, the HKMA might downgrade the composite CAMEL rating and/or raise the statutory minimum CAR of the AI under Pillar 2. A downgrade of the AI's composite CAMEL rating results in a higher premium charge, for the purpose of the DPS, for the year of assessment if the AI is a member of the DPS. This incentive applies to approximately three quarters of the AIs present in Hong Kong (covering over 99 percent of the deposits of the banking sector). The HKMA also exercises a closer supervisory regime if the CAMEL rating drops below a threshold. It is the HKMA's experience that Board members attach great importance to the composite CAMEL rating. Hence, AIs will typically take a proactive response in addressing the HKMA's concerns in order to avoid such a downgrade.

*(c) An external auditors review of an AI under BO section 59(2)*

The MA may, under BO section 59(2), and after consultation with the AI, require the AI to provide an external auditors' report on such matters as the MA may reasonably require for the performance of his functions under the BO, including, a review on the AI's internal control systems in specific areas of operation. The HKMA will seek timely rectification by AIs regarding the deficiencies identified by the external auditors from the review.

*(d) Supervisory guidance*

When the HKMA observes an issue affecting a number of AIs, or AIs or the banking

	<p>system generally, it might issue targeted guidance. Typically, such guidance would require AIs to take steps to strengthen their risk management. For instance, in the light of the exuberance in the Hong Kong property market in recent years, the HKMA has issued a series of circulars to AIs, since October 2009, to introduce altogether six rounds of “pre-emptive measures.” In discussion, the authorities indicated that their preference was to adopt as “preemptive” a stance as possible and therefore the issuance of supervisory guidance was seen as the first step in remedial action and in practice this option might be seen as the most commonly used of the supervisory remedies.</p> <p><i>(e) Exercising intervention powers</i> Although relatively rare, the MA has used its formal supervisory intervention powers under BO section 52. The assessors discussed a number of cases over the past 6 years in which such powers had been used. Notably most of these cases related to cross border issues and were handled in cooperation and collaboration with overseas authorities.</p> <p><i>Consultation with the FS</i> In order to exercise certain powers under the BO, for example under section 52 of the BO, the MA must first consult with the FS. This is a consultative requirement and not an approval requirement and the view of the FS is not binding on the MA. In view of the potential for there to be a judicial review, it is, however, most typical for the MA to use a standard written procedure to ensure that all legal requirements have been duly addressed. The procedure is designed to be executed with dispatch and can take under 24 hours but there is flexibility to act faster as needed. It is also typical for the MA to keep the FS abreast of developments so that the FS would not be unaware of the likelihood of being consulted in respect of a particular situation.</p>
<b>EC3</b>	<p>The supervisor has the power to act where a bank falls below established regulatory threshold requirements, including prescribed regulatory ratios or measurements. The supervisor also has the power to intervene at an early stage to require a bank to take action to prevent it from reaching its regulatory threshold requirements. The supervisor has a range of options to address such scenarios.</p>
<b>Description and findings re EC3</b>	<p><i>Powers to act when an AI's capital falls below the minimum requirements</i> In the event that an AI's capital falls below the minimum requirements, the AI and the MA are required by BO section 97E(1) to discuss what remedial actions should be taken. The MA is not bound by any such discussions. The MA may subsequently (under BO section 97E(2)) serve a notice in writing requiring the AI to take the remedial actions specified in the notice. It should be noted that not only (under BO section 97E(4)) failure to comply with any requirement contained in the notice served under BO section 97E(2), but also (under BO section 97D(3)) failure to notify the MA of contravention of the minimum CARs is an offence for which every director, chief executive and manager of the AI is liable to a fine and imprisonment.</p> <p>If an AI fails to comply with the minimum capital requirements (or to restore compliance by taking remedial actions), the MA may, after consultation with the FS:</p> <ul style="list-style-type: none"> <li>• require the AI to take any action or to do any act or thing whatsoever in</li> </ul>

	<p>relation to its affairs, business and property as he may consider necessary (e.g., to take steps to raise new capital or to dispose of certain assets) (section 52(1)(A));</p> <ul style="list-style-type: none"> <li>• appoint an Advisor or Manager for the AI (sections 52(1)(B) &amp; (C)), or report the case to the Chief Executive in Council with a view to the winding-up of the AI (section 52(1)(D) &amp; section 53(1)(iii)); or</li> <li>• suspend (sections 24 &amp; 25) the AI's authorization or</li> <li>• revoke (section 22) the AI's authorization. As a continuing authorization criterion under the BO Schedule 7 Paragraph 6, failure by an AI to maintain the statutory minimum capital requirement constitutes a ground for revocation of authorization under BO Schedule 8 Paragraph 2.</li> </ul> <p><i>Powers to intervene at an early stage to require an AI to take action to prevent it from reaching its regulatory threshold requirement</i></p> <p>If an AI's CAR falls close to the trigger or internal targets, it is the MA's general practice to discuss capital replenishment or asset disposal plans with the AI. Should the AI not take steps to improve its position and if the MA considers the AI's position might be detrimental to depositors (notwithstanding that the CAR is still above the minimum standard), the MA may exercise his powers to pursue various measures (such as those set out below) as appropriate, after consulting the FS:</p> <ul style="list-style-type: none"> <li>• require the AI to take any action or to do any act or thing whatsoever in relation to its affairs, business and property as he may consider necessary (e.g., to take steps to raise new capital or to dispose of certain assets) (section 52(1)(A));</li> <li>• appoint an Advisor for the AI (section 52(1)(B)).</li> </ul> <p>In such an instance, the HKMA may require the AI to provide an action plan on how to strengthen its capital position. The assessors discussed instances where the HKMA team had raised concerns with senior management and Board level representatives of the AI and this had led to managed capital injections. Alternatively, or additionally the HKMA might require AIs to restrict their dividend payment and/or to dispose of assets of higher risk weights to improve their capital adequacy where necessary.</p> <p>It is, however, the HKMA's experience that AIs address concerns raised seriously at an early stage. It has not been necessary for the MA to take any action under BO section 97E (or its predecessor) in relation to remedial action for contravention of the minimum statutory capital ratios.</p> <p><i>Liquidity</i></p> <p>In a parallel process to that applying to capital adequacy, failure by an AI to meet the minimum liquidity ratio requires that the MA and AI must (under BO section 104) discuss what remedial action should be taken, although the MA is not bound by this discussion and may serve a written notice to the AI to take such remedial actions as the MA sees fit. Should an AI fail to meet minimum liquidity requirements (or to restore compliance by taking remedial actions), the MA may, after consultation with the FS, exercise a range of powers under the BO as mentioned in the case of capital adequacy above.</p>
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	<p>Equally, if an AI's liquidity ratio falls close to the target liquidity ratio, the MA may, on the same basis and for the same reason as for capital adequacy, exercise his powers under the BO (e.g., section 52), after consulting the FS, to intervene at an early stage.</p> <p>Recent examples of failure to comply with liquidity ratios have stemmed from classification errors by the AI and were rectified promptly.</p>
<b>EC4</b>	<p>The supervisor has available a broad range of possible measures to address, at an early stage, such scenarios as described in essential criterion 2 above. These measures include the ability to require a bank to take timely corrective action or to impose sanctions expeditiously. In practice, the range of measures is applied in accordance with the gravity of a situation. The supervisor provides clear prudential objectives or sets out the actions to be taken, which may include restricting the current activities of the bank, imposing more stringent prudential limits and requirements, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from the banking sector, replacing or restricting the powers of managers, Board members or controlling owners, facilitating a takeover by or merger with a healthier institution, providing for the interim management of the bank, and revoking or recommending the revocation of the banking license.</p>
<b>Description and findings re EC4</b>	<p>In addition to its formal powers under the BO, noted below, the HKMA has a range of supervisory tools including, issuing specifically targeted guidance; imposing "agreed" supervisory measures; downgrading an AI's CAMEL rating and raising the minimum statutory CAR.</p> <p>When using formal powers under the BO, the MA has a broad range of possible actions available:</p> <p><i>Restricting current activities of an AI</i> The MA may do so through:</p> <ul style="list-style-type: none"> <li>• the supervisory intervention powers under BO section 52 which can be used, after consultation with the FS, (please see EC2);</li> <li>• revoking, or attaching condition(s) to, former approvals granted: (BO section 16(5) (attach conditions to authorization), sections 44(4) &amp; (5) (attach conditions to / revoke approval of local branch), sections 49(4) &amp; (5) (attach conditions / revoke approval of overseas branches and overseas representative offices), sections 51A(4) &amp; (5) (attach conditions / revoke approval of overseas banking corporations), sections 87A(4) &amp; (5) (attach conditions / revoke approval on acquisition of share capital in companies) and advising the SFC in the course of statutory consultation to attach / revoke conditions under SFO sections 119(5) &amp; (9) (attach / revoke conditions to the registration of an applicant for a regulated activity under the SFO); and</li> <li>• ordering the AI to take specific action pursuant to AMLO section 21(2).</li> </ul> <p><i>Withholding approval of new activities or acquisitions</i> The MA may refuse to grant approval for:</p>

	<ul style="list-style-type: none"> <li>• establishment of local branches (BO section 44);</li> <li>• in the case of locally incorporated AIs, <ul style="list-style-type: none"> <li>- establishment of overseas branches or representative offices (BO section 49);</li> <li>- establishment of overseas banking subsidiaries (BO section 51A); or</li> <li>- acquisition of share capital in companies (BO section 87A);</li> </ul> </li> </ul> <p>The MA may advise the SFC as to whether he is satisfied by the AI that the AI is fit and proper to be registered for a regulated activity, and the SFC shall have regard to the MA's advice (SFO section 119(3) &amp; (4)). Further, the MA may, in the course of statutory consultation, give his views to the SFC as to whether an AI's registration for regulated activities should be subject to conditions (SFO section 119(5)).</p> <p>The MA may stop an AI from engaging in new activities through powers under BO section 52. The powers are triggered whenever the MA considers an AI is conducting business in a manner detrimental to the interests of its depositors or potential depositors (please see the response to EC 2); and attaching condition(s) under BO section 16(5) to the AI's authorization</p> <p><i>Imposing more stringent prudential limits and requirements</i> The MA is empowered respectively under BO sections 97F and 105(1) to vary the minimum capital requirement and the minimum liquidity ratio applicable to any individual AI (e.g., to increase the respective requirements if there is doubt about the adequacy of the AI's capital or liquidity).</p> <p><i>Restricting or suspending payments to shareholders or share repurchase</i> The MA may do so through the powers under BO section 52 (please see EC 2).</p> <p><i>Restricting asset transfer</i> The MA may do so through:</p> <ul style="list-style-type: none"> <li>• the power to prohibit an AI from placing money (e.g., through granting any advances, loans or credit facilities) with a foreign bank (BO section 86); or</li> <li>• the powers under BO section 52 (please see EC2).</li> </ul> <p><i>Barring individuals from banking</i> The MA may refuse to grant approval to a person for becoming:</p> <ul style="list-style-type: none"> <li>• a controller of an AI incorporated in Hong Kong (BO section 70(6));</li> <li>• a chief executive of an AI (section 71(2));</li> <li>• a director of an AI incorporated in Hong Kong (section 71(2));</li> <li>• an executive officer of a registered institution<sup>31</sup> (section 71C(2)); or</li> <li>• an employee of an AI in certain circumstances (e.g., bankruptcy, conviction for an offence involving fraud or dishonesty) (section 73(1) and (1A)).</li> </ul>
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<sup>31</sup> "Registered institution" means an AI which is registered under the SFO to conduct regulated activities (e.g., securities intermediary activities).



	<p><i>Barring individuals from carrying on regulated activities under the SFO</i></p> <ul style="list-style-type: none"> <li>• The MA may suspend or remove the registration of relevant individuals for conducting regulated activities (BO section 58A);</li> <li>• The MA may withdraw or suspend consent from an executive officer of a registered institution (BO section 71C(4)).</li> </ul> <p><i>Replacing managers, directors or controlling owners</i></p> <p>The MA may, if he is no longer satisfied that the person concerned is fit and proper:</p> <ul style="list-style-type: none"> <li>• serve a notice of objection on an existing controller of an AI incorporated in Hong Kong (BO section 70A(3));</li> <li>• withdraw a consent formerly given under section 71(4) to a chief executive of any AI or to a director of an AI incorporated in Hong Kong.</li> </ul> <p>To be “fit and proper”, an individual should have, among other things, adequate knowledge, experience and competence for the position that he assumes (re: GTA Chapter 4, Guideline on Minimum Criteria for Authorization and SPM CG-2 Systems of Control for the Appointment of Managers). Thus, if any director, chief executive or manager of an AI is found to be not fit and proper (e.g., by virtue of being incompetent or not possessing the necessary skills and experience), the MA may withdraw his consent under BO section 71 (for directors and chief executives only) and/or consider the exercise of other powers under the BO (e.g., to direct an AI to remove those managers found to be not fit and proper under BO section 52 in serious cases).</p> <p>In more extreme cases, the MA might consider use of the supervisory intervention powers under BO section 52 (which can be used, after consultation with the FS, wherever the MA considers an AI is conducting business in a manner detrimental to the interests of its depositors or potential depositors) to appoint a Manager in respect of the AI. This appointment will have the effect of revoking the appointment of the chief executive and the directors of an AI incorporated in Hong Kong or removing the chief executive of the business in Hong Kong in the cases of overseas incorporated AIs (BO section 53B(1)).</p> <p>In practice where the competence or integrity of an AI's staff is in doubt, the HKMA will typically approach the AI's senior management (or even the Board if the concerned staff is a senior officer of the AI) to look into the matter. In many cases, the concerned staff will either be removed from their position or asked to leave by the AI. To date, no examples have arisen within the past five years, although the HKMA has had experience of having to raise such concerns. It may be noted (and in relation to CP8) that the management component of the CAMEL rating could trigger a downgrade in the composite rating as management is regarded as fundamental to the soundness of the institution.</p> <p><i>Restricting the powers of managers, directors or controlling owners</i></p> <p>The MA may:</p>
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	<ul style="list-style-type: none"> <li>• attach relevant conditions to the consent for a person to become or to be a controller of an AI incorporated in Hong Kong (BO section 70(7));</li> <li>• attach relevant conditions to the consent for a person to become or to be a chief executive of any AI or director of an AI incorporated in Hong Kong (BO section 71(5)); or</li> <li>• attach restrictions on voting and transfers of shares by persons who have become controllers without the MA's consent or who continue to be controllers after having been served with a notice of objection (BO section 70B(3)).</li> </ul> <p>Providing for interim management of an AI: The MA may appoint a Manager to manage the AI's affairs under BO section 52(1)(C).</p> <p><i>Revocation of the authorization of an AI</i> The MA may revoke an authorization under BO section 22.</p> <p><i>Takeover / merger of an AI</i> The supervisory intervention powers currently available to the MA under BO section 52 would not allow the MA to direct the transfer of the shares in an AI. Accordingly, whilst the MA could use his powers under BO section 52 to "hold the line" whilst a takeover or merger is negotiated, the MA could not force the shareholders of the AI to accept any takeover offer. While this is a commercial consideration for the individual institution and its shareholders, the HKMA has in the past assumed the role of an intermediary to facilitate the negotiation and matching process.</p> <p><i>Non-banking financial activities</i> With regard to AIs' securities business, the MA has, from time to time, recommended the SFC to take appropriate disciplinary actions (i.e. those under SFO Part IX) against AIs, their executive officers and relevant individuals and persons involved in their management. The MA may also, after consulting the SFC, remove or suspend the particulars of a relevant individual under BO section 58A(1) where the relevant individual is or was guilty of misconduct or the MA is of the opinion that the relevant individual is not, or has ceased to be, a fit and proper person. Further, under BO section 71C(4), the MA may withdraw or suspend consent from an executive officer, after consultation with the SFC, where the executive officer is or was guilty of misconduct or the MA has ceased to be satisfied that he is fit and proper or that he has sufficient authority within the AI.</p> <p>With respect to AIs' MPF business, the HKMA will assist the MPFA, if nominated by the MPFA to assist, to investigate possible unregistered selling / advising in relation to registered provident fund schemes and has power to investigate non compliance with performance requirements under the MPFSO. The MA, will refer the investigation results to the MPFA for its consideration of what actions (i.e. those under MPFSO Part IVA Division 8) should be taken against the AIs or regulated persons concerned.</p>
<b>EC5</b>	The supervisor applies sanctions not only to the bank but, when and if necessary, also to management and/or the Board, or individuals therein.
<b>Description and</b>	Contravention of many of the requirements under the BO constitutes an offence which

<b>findings re EC5</b>	<p>makes the directors, chief executives or managers of AIs liable upon conviction to imprisonment and fines. In such cases, the Department of Justice of the HKSAR Government may prosecute the concerned individuals in court, having regard (if considered appropriate) to the recommendation of the MA.</p> <p>The MA has the legal power to object to the controller of a locally incorporated AI and to withdraw consent from the chief executive of an AI or the director of a locally incorporated AI (BO sections 70A(3) and 71(4)).</p> <p>Also the MA, together with other authorities, has powers under the AMLO (section 21) to take disciplinary action against the financial institution for breaches of provisions relating to the customer due diligence and record-keeping requirements. Possible disciplinary actions include public reprimand, order to take remedial actions and pecuniary penalties. In addition, there is power under the AMLO section 79(1) for the MA to prosecute contraventions of specified provisions.</p> <p>In terms of an AI's securities business, the MA has power to impose disciplinary sanctions (BO sections 58A(1) and 71C(4)) on a relevant individual or executive officer who is guilty of misconduct or considered to be not fit and proper.</p> <p>The MA is not the prosecuting authority for offences under the BO. This power rests with the Department of Justice of the HKSAR Government. Accordingly, when contraventions of provisions of the BO come to light in circumstances indicating the potential commission of an offence, the MA will, as appropriate in light of the nature of the contravention, report the matter to the Department of Justice with a recommendation as to whether in the view of the MA prosecution is warranted. Prosecution is unlikely to be recommended for unintentional, more technical contraventions (e.g., late submission of documents, or late notification of specified matters) which are rectified promptly, whereas for more serious contraventions (e.g., suspected fraud or material malpractice) prosecution of directors, the chief executive and any managers who appear primarily responsible would be recommended.</p> <p>Serious contraventions leading to prosecution are, however, rare. There has been one case which led to fines levied at the District Court in 2009. Nevertheless, it is the MA's general practice to approach an AI when the MA has concerns with respect to the fitness and propriety of its management that stem from supervisory failures or breaches of standards. In these instances, the individuals concerned have left the AI following the MA's challenge to the AI on the competence of the individuals, as confirmed by the assessors' review of files.</p> <p>Formal actions in relation to misconduct in securities related activities have been taken by the HKMA or the SFC following referral from the HKMA including suspensions, fines and reprimands over the past six years. No prosecution case has yet been brought under the relatively recently implemented AMLO.</p>
<b>EC6</b>	<p>The supervisor has the power to take corrective actions, including ring-fencing of the bank from the actions of parent companies, subsidiaries, parallel-owned banking structures and other related entities in matters that could impair the safety and</p>

	soundness of the bank or the banking system.
<b>Description and findings re EC6</b>	As noted above, the MA has powers under section 52 of the BO to impose ring fencing arrangements. These powers have been exercised on a few occasions within the last five years, and in discussion with relevant overseas authorities, a fact confirmed by the assessors in review of documents provided by the HKMA.
<b>EC7</b>	The supervisor cooperates and collaborates with relevant authorities in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).
<b>Description and findings re EC7</b>	<p>The MA has a mandate, under BO section 7 to cooperate with other supervisory authorities (local or overseas) wherever appropriate. The MA interprets this obligation to include cooperation with respect to the orderly resolution of an institution, although at this time the MOUs do not refer specifically to resolution arrangements. The HKMA has however recently entered into a Resolution MoU with an overseas authority. Nonetheless, the MA has experience, within the last 5 years, of participating in and assisting the resolution of a bank, and cooperating with overseas authorities. Based on the papers the assessors were able to see, the arrangement and working relationships were effective.</p> <p>To facilitate working arrangements, the HKMA has established MoUs with both domestic and relevant overseas authorities. These MoUs set out expectations on information exchange and cooperation including in relation to notification between the authorities in cases of such issues as material concerns arising or action taken against an AI.</p>
<b>Additional criteria</b>	
<b>AC1</b>	Laws or regulations guard against the supervisor unduly delaying appropriate corrective actions.
<b>Description and findings re AC1</b>	<p>The BO does not impose any specific time limits on the MA for the taking of any supervisory actions. Nevertheless, Interpretation and General Clauses Ordinance section 70 stipulates that where no time is prescribed or allowed within which anything shall be done, such thing shall be done without unreasonable delay, and as often as due occasion arises.</p> <p>Moreover, the BO itself creates an expectation of timely action as, for example, a number of provisions state that actions should be carried out "as soon as reasonably practicable." For example, sections 71 and 73 refer to giving written notice by the MA to an AI and the person applying to be the chief executive or director or employee of the AI regarding the granting, or refusal of granting, the relevant consent.</p> <p>Under administrative law principles, the MA is required to act reasonably in all circumstances and that includes within reasonable time. Anyone aggrieved by undue delay by the MA could seek relief by way of judicial review which could result in an order from the court to take action.</p> <p>Internal governance arrangements, including internal audit practices, provide a framework for the HKMA to ensure its actions are carried out in a timely manner.</p> <p>In reviewing the material the HKMA were able to provide, there was no indication that</p>

	the HKMA delayed actions or intervention when an issue was identified. Firms with whom the assessors spoke commented on the responsiveness of the HKMA to issues which required action.
<b>AC2</b>	When taking formal corrective action in relation to a bank, the supervisor informs the supervisor of non-bank related financial entities of its actions and, where appropriate, coordinates its actions with them.
<b>Description and findings re AC2</b>	Although there is no formal policy statement, most of the MoUs which the HKMA has signed specify the arrangements and expectations in terms of notification and coordination in cases where corrective action is to be carried out. In practice, in relation to corrective actions, including revocation, the HKMA ensured that relevant authorities were kept informed. The assessors were able to confirm this through review of appropriate correspondence.
<b>Assessment re principle 11</b>	Compliant
<b>Comments</b>	<p>The HKMA has a strong set of powers under the BO and the HKMA has developed a firm reputation of being a reasonable but assertive authority which does not hesitate to act or to escalate its actions if necessary. In practice, the HKMA prefers preventative measures to remedial measures whenever possible, a stance that was confirmed by the assessors in dialogue with the industry. There is, however, no evidence of supervisory forbearance and the assessors' review of extensive material provided by the HKMA, in addition to industry dialogue, indicated that the HKMA can and does use its range of powers in a timely manner.</p> <p>The BO imposes an obligation on the MA to consult with the FS prior to the exercise of certain of these powers, but even were the FS not to support the MA's proposed action under the BO, the MA has the power to carry out the remedial action if he determines this to be necessary. In practice there is no instance of the FS not having supported the MA decision and arrangements are in place to ensure a swift process of consultation to avoid any possible delay. The Chief Executive of HKSAR may, under section 10 of the BO, give directions to the MA with respect to the exercise of the MA's functions under the BO the effect of which could, theoretically, be to override the decision, but this issue is considered under CP2.</p>
<b>Principle 12</b>	Consolidated supervision. An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide. <sup>32</sup>
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor understands the overall structure of the banking group and is familiar with all the material activities (including non-banking activities) conducted by entities in the wider group, both domestic and cross-border. The supervisor understands and assesses how group-wide risks are managed and takes action when risks arising from the banking group and other entities in the wider group, in particular contagion and reputation risks, may jeopardize the safety and soundness of the bank and the banking

<sup>32</sup> Please refer to footnote 19 under Principle 1.

	system.
<b>Description and findings re EC1</b>	<p>Under BO section 7(2)(g), the MA has the responsibility to take all reasonable steps to ensure that any business carried on by an AI is carried on with integrity, prudence and the appropriate degree of professional competence and in a manner which is not detrimental, or likely to be detrimental to the interests of depositors or potential depositors. To discharge his statutory responsibility effectively, the MA has to, among other things, evaluate the risks that may be posed to an AI in a group by the material activities (including non-banking activities) conducted by entities in the group.</p> <p>BO Schedule 7 Paragraph 12 also specifies that “business” includes any business that is not banking business or the business of taking deposits.</p> <p><i>Information-gathering powers under the BO</i></p> <p>The following provisions in the BO empower the MA to obtain the necessary information for understanding the overall structure and major activities of a group in which an AI is the parent or a member:</p> <ul style="list-style-type: none"> <li>• section 63(2): The MA may require an AI to submit such further information (i.e. other than that required under section 63(1) which principally relates to the information that should be submitted to the MA monthly and quarterly in the form of certain banking returns) as he may reasonably require for the exercise of his functions under the BO;</li> <li>• section 63(2A): The MA may require any holding company of an AI, any subsidiary of such holding company, or any subsidiary of an AI to submit such information as he may reasonably require for the exercise of his functions under the BO;</li> <li>• section 64: The MA may require an AI to submit the name, address and the nature of business of every company: <ul style="list-style-type: none"> <li>• in which the AI holds 20 percent or more of the share capital;</li> <li>• where any director or manager of that company is also a director, chief executive or manager of the AI;</li> <li>• where the name of that company has common features with the name of the AI;</li> <li>• which acts in concert with the AI to promote the AI’s business; or</li> <li>• the controller of which is also the controller of the AI.</li> </ul> </li> </ul> <p>The HKMA adopts a risk-based approach to supervising AIs, as set out in SPM SA-1 “Risk-based Supervisory Approach.” The objective of the supervisory framework is to provide an effective process to monitor and assess the safety and soundness of AIs on a continuing basis using a risk-based approach to establish a forward-looking view on the risk profile of AIs and to focus on the areas of greatest risk to an AI.</p> <p>SPM SA-1 is complemented by SPM CS-1 “Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions” which elaborates the group-wide approach adopted by the HKMA to supervising AIs where they form part of a group as part of its risk-based supervisory process.</p> <p>The group-wide approach set out in SPM CS-1 takes account of the risks to an AI from</p>

	<p>its downstream operations (i.e. its offices, subsidiaries, associated companies and joint ventures, both domestic and foreign), as well as from other companies (financial or non-financial) in the group when the AI is a member of either a group controlled by an overseas regulated parent company or of a group controlled by an unregulated parent company. The HKMA has the responsibility to assess whether there are any significant issues or weaknesses at the group level that could threaten the position of an AI, in particular, losses arising from either the AI's direct financial exposure to the rest of the group or a loss of reputation resulting from contagion from problems elsewhere in the group.</p> <p>To discharge such responsibilities, the HKMA develops an adequate understanding of the structure, major activities and management of a group, both domestic and cross-border and including non-banking activities, of which an AI is a member.</p> <p>SPM CS-1 Paragraphs 5.2.9 and 6.2.5 set out the remedial actions that the MA may take to contain the risks arising from the group.</p> <p>In many cases, local AIs are subsidiaries of international banking groups, and hence the ultimate consolidated supervision of the relevant financial group rests with the home banking regulators.</p> <p>There are only a few cases in Hong Kong where no holding company of a locally incorporated licensed bank (hereafter referred to as "local bank") is either supervised by the MA or an overseas banking regulator. For these few cases, the local bank generally forms a dominant part of the group to which it belongs.</p> <p>In Q3 2013, the HKMA implemented an enhanced framework for the consolidated supervision of banking groups to obtain an adequate degree of oversight over the holding companies of local banks based on the MA's power to attach conditions to the consent given for them to be majority shareholder controllers of local banks under BO section 70. This framework is applicable to cases where no holding company of a local bank is a regulated entity.</p> <p><i>Overview of the HKMA's supervisory approach</i></p> <p>The starting point for the HKMA's supervision of a local AI is its "solo" position (i.e. "solo-based supervision" covering the local AI's Hong Kong offices and its overseas branches). The HKMA supervises both banking and non-banking activities of local AIs. In most cases, the activities of local AIs are predominantly banking business.</p> <p>In situations where a local AI is the parent company of a number of subsidiary operations, the solo-based supervision is supplemented by an assessment of the risk profile and strength of the AI and its subsidiary operations, and imposing prudential standards on the group (referred to as "consolidated supervision").</p> <p>Additionally, where a local AI forms part of a wider group which is headed by a common holding company, the solo and consolidated supervision is further supplemented by appropriate review of the holding company and other companies of the group of which the local AI forms a part (referred as "controller group review").</p>
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	<p><i>Understanding overall structure, material activities and risk management practices</i></p> <p><i>Consolidated level (i.e. a consolidated group headed by the local AI)</i></p> <p>The BSD seeks to understand and monitor local AIs' group structures, material activities (including those conducted by their subsidiaries), and group-wide risk management practices at the consolidated level through its on-going supervisory process, including meeting with senior management as well as Board or Board-level committees of local AIs, off-site review of information collected from the local AIs, on-site examinations of local AIs' local and overseas operations, and supervisory cooperation with other domestic and overseas regulators.</p> <p>The typical information collected from a local AI for review includes, among other things, (i) group structure chart, (ii) list of subsidiaries and nature of their businesses, (iii) business strategy and financial budget, (iv) minutes of the meetings of the Board of directors, Board-level and senior management committees, and the information packs submitted to them, (v) internal audit reports, (vi) consolidated stress testing results, (vii) financial statements and other relevant information in respect of key subsidiaries; and (viii) internal capital adequacy assessment. These documents contain key prudential information about the local AI on a solo basis as well as consolidated basis. Depending on the materiality of a subsidiary to its parent AI, the BSD may also require the AI to submit the Board and committee meeting minutes and internal management information reports of such subsidiary on a regular basis (e.g., monthly).</p> <p>In addition to its off-site reviews and local and overseas on-site examinations, the BSD also leverages off the work performed, and information shared, by other domestic and/or overseas regulators, where appropriate, in exercising consolidated supervision.</p> <p>Where non-bank subsidiaries of a local AI (e.g., securities firms or insurance companies) are supervised by other domestic regulators (e.g., the SFC or IA), the HKMA co-operates and exchanges information with these regulators under MoUs to ensure effective supervision of the banking group.</p> <p><i>Wider group level (i.e. a wider group headed by the local AI's holding company)</i></p> <p>The understanding of the structure and material activities within the wider group starts with the HKMA's handling of the application submitted by the intended holding company to become a majority shareholder controller of a local AI. After the MA's consent under BO section 70 is granted, the BSD continues to monitor the fitness and propriety of the holding company as a majority shareholder controller. The BSD keeps track of major developments relating to the holding company and the wider group by collecting information through the local AI or directly from the holding company where appropriate and monitoring public information. In the cases where the holding company of an AI is a regulated entity, the BSD also maintains supervisory cooperation with the home regulator of any controller that is a regulated financial institution in the course of ongoing supervision.</p> <p><i>Taking action in relation to risks arising from the banking group and other entities in the wider group</i></p>
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	<p><i>Consolidated level (i.e. a consolidated group headed by the local AI)</i>                  If the BSD identifies any major risk arising from the operations of a local AI's subsidiary, this may call into question whether the AI has an adequate system of control over its subsidiaries and whether its business, as conducted through its holding of the subsidiary, is conducted with prudence for the purposes of BO Schedule 7. In such circumstances, the BSD will seek to ensure that the local AI requires its subsidiary to take the necessary action to rectify the issue in a timely manner.</p> <p><i>Wider group level (i.e. a wider group headed by the AI's holding company)</i>                  In the situation where the BSD considers that the condition or activities of the holding company of a local AI or of other entities within the wider group pose risk to the local AI, the BSD takes action to contain the relevant risk, such as through restricting the exposures of the local AI to other group entities.</p>
<b>EC2</b>	<p>The supervisor imposes prudential standards and collects and analyses financial and other information on a consolidated basis for the banking group, covering areas such as capital adequacy, liquidity, large exposures, exposures to related parties, lending limits and group structure.</p>
<b>Description and findings re EC2</b>	<p>Under the BO, the MA has the power to impose prudential standards on a consolidated basis (i.e. consolidation that includes an AI and its subsidiaries) in respect of the following aspects:</p> <p><i>Large exposures, lending limits and exposures to related parties</i>                  BO Part XV sets out the statutory limitations on large exposures, connected lending, holding of share capital, and holding of interests in land. BO section 79A empowers the MA to require a locally incorporated AI that has any subsidiary to comply with these statutory limits on a consolidated basis. In addition, as mentioned in SPM CR-G-8 "Large Exposures and Risk Concentrations" sections 4.2 and 5.2, such AI is expected to observe an internal clustering limit (i.e. for control of the aggregate of large exposures not exempted under BO section 81) and other prudential limits, if any, agreed with the HKMA. Where applicable, these limits should be set on both a solo and consolidated basis.</p> <p>SPM CR-L-1 "Consolidated Supervision of Concentration Risks under Part XV: §79A" sets out the general principles governing the application of consolidated supervision of concentration risk and explains how the MA will apply these principles.</p> <p><i>Capital adequacy</i>                  BO section 97C(3)(d) and BCR section 3C empower the MA to require a locally incorporated AI that has any subsidiary to comply with capital requirements on a consolidated basis.</p> <p><i>Liquidity</i>                  BO section 102(3A) empowers the MA to require a locally incorporated AI to comply with the minimum liquidity ratio on a consolidated basis (i.e. covering such subsidiaries and overseas branches specified by the MA under BO section 102(3B)).</p>

	<p><i>Group structure</i> SPM CG-1 “Corporate Governance of Locally Incorporated Authorized Institutions” section 2.7 requires the Board and senior management of an AI to understand and guide the AI’s structure and organization and ensure that organizational complexity does not prevent effective control of the AI’s activity in its entirety. (See Principle 14 EC 8 for more details.)</p> <p><i>Collection and analysis of financial and other information</i> The MA may under BO section 63(2A) require the holding company of an AI, any subsidiary of such holding company and any subsidiary of the AI to provide consolidated financial information for review.</p> <p>As set out in SPM CS-1 “Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions” section 5.4, consolidated information up to the AI collected by the HKMA usually includes:</p> <ul style="list-style-type: none"> <li>• banking returns on capital adequacy, liquidity and large exposures on a consolidated basis covering subsidiaries and overseas offices specified by the MA;</li> <li>• organization chart;</li> <li>• group risk management structure and policies;</li> <li>• audited consolidated financial statements of the AI; and</li> <li>• risk management reports at the group level (e.g., on large exposures, connected exposures, capital adequacy, liquidity risk and other major risks).</li> </ul> <p>If the AI is part of a wider group, the HKMA generally expects the controller of the AI to submit information on a regular basis (SPM CS-1 section 6.4). The information may include:</p> <ul style="list-style-type: none"> <li>• group organization chart;</li> <li>• overview of the group risk management framework; and</li> <li>• audited financial statements of other relevant group companies that are considered by the HKMA to have a material potential impact on the AI.</li> </ul> <p>The provision of such information may be formally required through conditions attached to the MA’s approval for the controller to become such controller (BO section 70).</p> <p>In practice, the HKMA sets prudential standards on a consolidated basis for the banking group, as follows:</p> <p><i>Consolidated level (i.e. a consolidated group headed by the local AI)</i> The HKMA imposes statutory prudential limits on capital adequacy, liquidity, large exposures, and connected lending not only on a solo basis but also on a consolidated basis covering such offices, branches and subsidiaries as specified by the HKMA in each case.</p> <p>Generally, subsidiaries undertaking financial businesses or activities are included for</p>
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	<p>the consolidated calculation of capital adequacy, large exposures and connected lending. As regards the liquidity position, the HKMA requires consolidation of selected subsidiaries or overseas branches of a local AI in cases where, for example:</p> <ul style="list-style-type: none"> <li>(i) when there are material back-to-back transactions between parent bank and subsidiary;</li> <li>(ii) when the Hong Kong operations of the local AI deploy a significant part of its surplus liquidity through some subsidiaries or overseas branches; and</li> <li>(iii) when a significant amount of offshore deposits is booked with some subsidiaries or overseas branches.</li> </ul> <p><i>Wider group level (i.e. a wider group headed by the AI's holding company)</i> As mentioned earlier, the HKMA has in Q3 2013 implemented an enhanced framework for the consolidated supervision of banking groups. This framework is applicable to cases where no holding company of a local bank is a regulated entity. Under the enhanced framework, the ultimate holding company (UHC) of a local bank is generally required to establish a holding company incorporated in Hong Kong (IHC) whose sole purpose is to hold the shares in the existing or proposed local AI (the IHC may however conduct other business or activities if they are for the purposes of providing support to the business or activities of the existing or proposed AI). This IHC is itself required, by means of the conditions attached to the consent given to it under BO section 70, to observe prudential standards and other requirements (such as those on capital adequacy, liquidity, large exposures, intra-group exposures, risk concentration, scope of activities, systems and controls, and submission of information) "as if the IHC were a local bank" where appropriate.</p> <p>At the UHC level, as the UHC Group may engage in non-financial activities, it may not be practical to require the company to observe prudential standards applicable to AIs. Hence, the conditions focus on containing the influence of the UHC on the local bank and regular submission of information by the UHC to facilitate the BSD's assessment of its financial condition, its ability to provide support to the local bank in case of need, and the risks related to its major activities.</p> <p>The HKMA also collects and analyses financial and other information on a consolidated basis, as follows:</p> <p><i>Consolidated level (i.e. a consolidated group headed by the local AI)</i> The BSD assesses and takes into account the information contained in statutory returns and other internal management reports collected from local AIs in conducting its consolidated supervision.</p> <p>The BSD generally requires local AIs under BO section 63(2) to submit certain statutory returns including the Return on Large Exposures, Return on Liquidity Position, Certificate of Compliance, Return on CAR, and Part II of the Return of External Positions on a consolidated basis (in addition to HK office position/solo basis) where applicable.</p> <p>As part of its risk-based supervisory approach, the BSD also collects from local AIs</p>
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	<p>additional data (including on their subsidiaries) if it considers it necessary in order to monitor the safety and soundness of individual local AIs and the banking system. For example, in view of the growing significance of local AIs' operations in Mainland China, the BSD introduced a new Return of Mainland Activities to collect more granular information in respect of local AIs' banking subsidiaries in Mainland China.</p> <p>Apart from the statutory returns mentioned above, the BSD also requires some local AIs to provide additional information (e.g., balance sheet, profitability and loan quality) on a consolidated basis to facilitate the BSD's assessment of the financial strength of an AI and the risks inherent in its downstream operations. In addition, the BSD also obtains from the local AI information, as set out in Principle 12 EC 1, including internal management reports containing key information in respect of the local AI on a consolidated basis as well as the major entities and major overseas operations within the consolidated group where appropriate.</p> <p><i>Wider group level (i.e. a group headed by an AI's holding company)</i> As regards the collection and analysis of information about local AIs' holding companies and the wider group, refer to EC 1 above for the relevant processes. The MA has the power under BO section 63(2A) to collect information from the holding companies and/or fellow subsidiaries of local AIs. The enhanced framework for the consolidated supervision of banking groups as discussed above provides an additional means for the BSD to collect information from unregulated holding companies of local banks on a regular basis or as the MA considers necessary. In addition, it has been the general practice of the BSD to require an individual local bank that forms part of a wider banking group to submit information about its exposures to the rest of the wider group to which it belongs.</p>
<b>EC3</b>	<p>The supervisor reviews whether the oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) is adequate having regard to their risk profile and systemic importance and there is no hindrance in host countries for the parent bank to have access to all the material information from their foreign branches and subsidiaries. The supervisor also determines that banks' policies and processes require the local management of any cross-border operations to have the necessary expertise to manage those operations in a safe and sound manner, and in compliance with supervisory and regulatory requirements. The home supervisor takes into account the effectiveness of supervision conducted in the host countries in which its banks have material operations.</p>
<b>Description and findings re EC3</b>	<p>As provided for under SPM CS-1 Paragraph 5.6.1, the prudential supervision of the HKMA as the home regulator of an AI extends to its overseas operations. The HKMA will therefore review the adequacy of the oversight of an AI's foreign operations by its Board and senior management according to the corporate governance and risk management standards set out in HKMA guidance (e.g., SPM CG-1). For overseas operations in the form of branches and banking subsidiaries that are regulated by banking supervisors in the host jurisdictions, the HKMA will exercise consolidated supervision in close cooperation with the relevant host supervisors through periodic supervisory contacts and exchange of information.</p> <p>The BSD evaluates the adequacy and effectiveness of a local AI's oversight and control</p>

	<p>of its overseas banking operations during the course of its ongoing supervision of the AI. This includes understanding and evaluating the oversight and control framework over the overseas operations mainly through ongoing discussion with the relevant management of the AI, reviewing the AI's internal management reports, and conducting on-site examinations. Areas reviewed include comprehensiveness of compliance and internal audit programs customized for the risk profile of the overseas operations, reasonableness of risk limits delegated to overseas staff, quality of MIS reporting, the risks and activities of overseas operations to the head office, relevant local experience of staff, and pro-activeness of management responses to issues identified by host supervisors.</p> <p>It has been the general practice of the BSD to require local AIs to provide internal management reports in addition to normal banking returns for review. Examples of these reports include Board submission papers, Asset-Liability Committee information packs, risk management reports, etc. Review of these reports assists the BSD in assessing whether sufficient information is regularly submitted to the senior management and Board of the local AI to enable their effective oversight of the AI's foreign operations.</p> <p>Separately, when planning for and determining the scope of on-site examinations, the BSD will consider the need to cover the adequacy of the oversight of overseas operations by the management in Hong Kong.</p> <p>It is the HKMA's practice not to grant approval for establishing branches or subsidiaries in countries where there are secrecy constraints that would inhibit effective consolidated supervision by the HKMA and where the HKMA has doubt about the ability of the AI concerned to collect information from the proposed overseas operations for the purposes of exercising adequate oversight over these operations.</p> <p>The BSD conducts on-site examinations of an AI's overseas operations and pays visits to host regulators from time to time. It has been the BSD's practice to seek comments from the relevant overseas host regulators (during its overseas visits or meetings with those host regulators) on the AI's local management as part of the discussion on the AI's operations under the purview of the host. Moreover, the BSD will itself assess, as part of its examination of an AI's overseas operations, whether the relevant senior management of the AI's overseas operations have properly discharged their oversight responsibilities and whether the risk management and internal control systems for the operations are sufficiently robust. When meeting with the local management during the on-site examination, the BSD pays special attention to whether they possess good knowledge of the local market and have a clear understanding of the corporate strategy of the AI.</p> <p>An assessment of the adequacy of host supervision is initially conducted when an application to establish an overseas branch or subsidiary is received from an AI. Following the grant of approval, the BSD will continue to pay attention to news or other available information concerning the host regulator (whether obtained from its direct supervisory contacts with the host regulator or otherwise) that may have a</p>
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	bearing on the AI's foreign operations.
<b>EC4</b>	The home supervisor visits the foreign offices periodically, the location and frequency being determined by the risk profile and systemic importance of the foreign operation. The supervisor meets the host supervisors during these visits. The supervisor has a policy for assessing whether it needs to conduct on-site examinations of a bank's foreign operations, or require additional reporting, and has the power and resources to take those steps as and when appropriate.
<b>Description and findings re EC4</b>	<p>Under BO section 55, the MA has the power to conduct on-site examinations on the overseas branches, representative offices and subsidiaries of a locally incorporated AI. The legal power to require additional information (other than that reported in the banking returns) is set out in BO sections 63(2) and (2A).</p> <p>The HKMA uses a risk-based approach to supervising AIs under which the HKMA will assess, among other things, the risk level of an AI's overseas operations to determine whether additional reporting or on-site examinations are required.</p> <p>The BSD determines the frequency of the periodic on-site examinations on the overseas branches and banking subsidiaries of local AIs having regard to a number of factors, including the business nature, complexity, size and risk profile of their operations. For example, in the light of the size and rapid expansion of the Mainland operations of local AIs, the minimum frequency of on-site examination of an AI's operations in Mainland China is once a year in general. In 2012, the BSD conducted 15 overseas examinations.</p> <p>It is the usual practice of the on-site examination team, during overseas visits, to meet with the relevant local supervisors in order to exchange views on examination findings, and prudential issues in respect of AIs' overseas operations and group companies under their supervision.</p> <p>Resources are allocated according to the results of the assessments conducted under the Risk-based Supervisory Approach so that adequate resources can be allocated to areas that merit more attention.</p> <p>In addition to the basic information (e.g., assets and liabilities as well as profitability) relating to local AIs' overseas operations collected from banking returns, the BSD also requires a local AI to submit other information (such as more detailed breakdowns of financial data, internal MIS reports, internal audit reports on overseas operations, annual audited accounts, audit management letter in the case of subsidiaries etc.) where appropriate.</p>
<b>EC5</b>	The supervisor reviews the main activities of parent companies, and of companies affiliated with the parent companies, that have a material impact on the safety and soundness of the bank and the banking group, and takes appropriate supervisory action.
<b>Description and findings re EC5</b>	As described in SPM CS-1 "Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions" section 3, the HKMA adopts a "group-wide approach" to the ongoing supervision of AIs. In other words, in assessing the financial

	<p>strengths and weaknesses of an AI, the HKMA will have regard to the impact of conditions at parent and sister companies that could adversely affect the condition of the AI.</p> <p>SPM CS-1 section 6 describes the supervisory process in relation to parent companies that are not AIs (whereas parent AIs would be subject to direct supervision of the HKMA as any other AI). The power of the HKMA to review the activities of these parent companies and of companies affiliated with the parent companies rests on the MA's statutory power under BO section 70 to approve controllers of a locally incorporated AI. In order to establish that a controller remains fit and proper as a controller of an AI, the HKMA will conduct a "controller group review" to assess the fitness and propriety of the controller covering the main activities and operations of the controller, and also the operations of the companies affiliated with the controller (i.e. sister companies of the AI) to the extent that they could have a material impact on the AI.</p> <p>Where necessary, the HKMA may employ assessment tools similar to prudential standards expected of AIs (e.g., in terms of capital adequacy, liquidity, large exposures, connected lending, etc.) in assessing the financial soundness of the group as a whole. To facilitate an assessment of a group to which an AI belongs, the MA is empowered under BO section 63(2A) to require any holding company of the AI or any subsidiary of any such holding company to submit such information that the MA considers he reasonably requires for the exercise of his functions under the BO.</p> <p>Also, in the case of an AI that is a subsidiary of a local banking group, the HKMA will, in assessing the AI's capital adequacy in respect of reputation risk, consider whether the financial position, reputation or conduct of the parent bank or head office, or any other member of the group could undermine confidence in the AI through "contagion" (see SPM CA-G-5 Annex B: Factors for assessing capital adequacy under SRP section B2.6).</p> <p>Where there are supervisory concerns in view of the corporate structures or activities of the related entities of an AI, a number of supervisory tools, including those set out in SPM CS-1 Paragraph 6.2.5, are available to the MA to bring about corrective actions. The tool to be used will depend on the severity of the issue and the risk posed to the AI concerned.</p> <p>In practice, the controller group review involves obtaining an understanding of, and monitoring major developments in relation to, the structure of and the major operations within the group. The extent and mode of such process depend on, among others, the structure and business nature of the group. As mentioned in EC 1 of this Principle, most local AIs are subsidiaries of international banking groups. In these cases, the BSD may leverage on the supervisory cooperation arrangements in place with other regulators (e.g., supervisory colleges) in monitoring the developments and risk profiles of the group. For cases where no holding company of a local bank is a regulated entity, the holding company is subject to the enhanced consolidated supervision framework described in EC 2 above. To the extent necessary in each case, the BSD pays special attention to the following factors:</p>
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	<ul style="list-style-type: none"> <li>(i) the legal, managerial, and operational structures of the group;</li> <li>(ii) the high-level corporate governance and risk management of the group as a whole (see SPM CS-1 Paragraphs 6.3.2 and 6.3.3);</li> <li>(iii) the principal risks inherent in the group;</li> <li>(iv) the nature and sufficiency of the controller's financial resources; and</li> <li>(v) the risk management processes and internal control mechanisms at group level.</li> </ul> <p>The BSD obtains information on the above through various sources, such as requesting the local AI or its parent company to submit information about the activities of the group as and when necessary and collecting publicly available information relating to the group including stock exchange announcements, public filings and disclosures, and press reports etc. In the cases where the local AI is the subsidiary operation of an international banking group, the BSD also obtains information about the parent company and, where appropriate sister companies, of the AI through ad-hoc and regular supervisory contacts with the home regulator and fellow host regulators. The BSD has been actively participating in the supervisory colleges and CMGs for a number of international banking groups. This enables the BSD to gain insight about the operations and risk profiles of the parent company and major sister companies of the local AI.</p> <p>If the BSD identifies any major supervisory concern in respect of the corporate structures or activities of the parent company or other related entities of the local AI, it will discuss such concerns with the AI, its parent company or the home regulator where appropriate with a view to identifying and agreeing solutions to address the issue. If necessary, the BSD may consider imposing ring-fencing measures on the local AI or recommend the MA to exercise his powers under the BO to take appropriate actions to contain the risks.</p>
<b>EC6</b>	<p>The supervisor limits the range of activities the consolidated group may conduct and the locations in which activities can be conducted (including the closing of foreign offices) if it determines that:</p> <ul style="list-style-type: none"> <li>(a) the safety and soundness of the bank and banking group is compromised because the activities expose the bank or banking group to excessive risk and/or are not properly managed;</li> <li>(b) the supervision by other supervisors is not adequate relative to the risks the activities present; and/or</li> <li>(c) the exercise of effective supervision on a consolidated basis is hindered.</li> </ul>
<b>Description and findings re EC6</b>	<p>The MA may limit activities of a locally incorporated AI through the statutory powers given in the BO.</p> <p>If the BSD has concerns about the activities conducted by a local AI and/or its subsidiary, it will express the concern to the AI and request the AI to take remedial actions in a timely manner. Where necessary, the BSD may request the AI to restrict, or require its subsidiary to restrict, the relevant activities. In case of need, the MA may exercise various powers under the BO to impose the restrictions where appropriate.</p>



	<p>If there are control weaknesses in an AI's overseas operations, the BSD will discuss appropriate remedial measures with the AI's management to enhance the systems of control. If necessary, the AI will be required (where necessary through the attachment of conditions to relevant approvals) to restrict the business activities and limit the exposures of the overseas operations before the identified weaknesses are rectified or to replace any local management considered primarily responsible for the weaknesses. The BSD will also draw the attention of the host supervisor to the situation, where appropriate. If the situation warrants, the BSD may revoke the approval previously granted for the establishment of the overseas operations.</p> <p>If an identified problem stems from inadequate supervision exercised by the host supervisor, the BSD may, as a short-term measure, impose ring-fencing measures in consultation with the AI in order to limit further exposures to, and activities of, the overseas office concerned. In the absence of any forthcoming improvement in the supervisory environment, the BSD may require the AI to close the relevant overseas operation. In addition, the MA can exercise his powers to revoke his approval previously granted for the establishment of the overseas operation.</p> <p>With regard to the wider group level (i.e. a group headed by an AI's holding company), while the MA has no other direct legal power to instruct AIs' shareholder controllers to restrict their operations (except in relation to the establishment or acquisition of overseas banking corporations by a locally incorporated holding company of a locally incorporated AI), he is empowered to revoke the approval under the BO for them to continue as shareholder controllers or attach conditions to such approval if needed. Although such a regulatory handle is in place, the MA has seldom needed to invoke it for the purpose of restricting the operations of group companies as such challenges have rarely been faced in practice. In case the HKMA considers that the condition or activities of the holding company of an AI or of other entities within the wider group pose risk to the AI, the HKMA may impose ring-fencing measures (including restriction on intragroup exposures) on the AI to contain the risk.</p>
<b>EC7</b>	<p>In addition to supervising on a consolidated basis, the responsible supervisor supervises individual banks in the group. The responsible supervisor supervises each bank on a stand-alone basis and understands its relationship with other members of the group.<sup>33</sup></p>
<b>Description and findings re EC7</b>	<p>As mentioned in SPM CS-1 "Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions" Paragraph 4.1, the starting point for the HKMA's supervision is an AI's "combined" or "solo" position (i.e. covering its Hong Kong offices and overseas branches).</p> <p>As mentioned in EC 1 above, the BSD supervises each AI individually on a stand-alone basis and takes steps to understand each AI's relationship with other members of the group. In particular, the BSD generally requires individual AIs to observe statutory and regulatory requirements on both a solo basis and a consolidated basis. The BSD</p>

<sup>33</sup> Please refer to Principle 16, AC 2.

	<p>generally requires AIs to provide information about their organization structures, business operations and financial performances at entity level in addition to consolidated level. To monitor their financial positions and compliance with relevant sections of the BO, the BSD also requires individual AIs to submit periodic banking returns prepared on different bases.</p> <p>If an AI is the parent company (the parent AI) of another AI (the subsidiary AI), the BSD supervises the parent AI on a solo basis (i.e. on a stand-alone basis) and on a consolidated basis (i.e. covering the parent AI, its subsidiary AI(s) and other relevant subsidiaries). The BSD generally conducts an annual CAMEL rating review and Supervisory Review Process for the parent AI and its subsidiary AI(s) separately. In evaluating the parent AI, the BSD assesses possible contagion risk arising from the subsidiary including the need to provide parental support.</p> <p>With respect to the subsidiary AI, the BSD supervises the subsidiary AI on a solo basis (i.e. stand-alone basis) and on a sub-consolidated basis (i.e. covering the subsidiary AI and its relevant subsidiaries). The BSD requires the subsidiary AI to submit its own information and banking returns in accordance with the regulatory requirements. The BSD reviews the level and form of parental support (including financial and operational support) available to the subsidiary.</p> <p>To understand an AI's relationship with other members of the group, the BSD obtains information about the ownership structure of the group and the AI's financial, operational and managerial interconnectedness with other key entities within the group where appropriate. For financial interconnectedness, the BSD monitors the AI's exposures to, and funding arrangement with, other group members. For operational interconnectedness, the AI is required to conduct risk assessment of any outsourcing / insourcing arrangement and discuss with the HKMA in advance any plans for any such arrangement. For managerial interconnectedness, the BSD will look at the management structure and the roles and reporting lines of the senior management of the AI with the rest of the group.</p>
<b>Additional criteria</b>	
<b>AC1</b>	For countries which allow corporate ownership of banks, the supervisor has the power to establish and enforce fit and proper standards for owners and senior management of parent companies.
<b>Description and findings re AC1</b>	<p>In Hong Kong, the controllers of an AI can be individuals or companies. The authorization criteria set out in BO Schedule 7 Paragraphs 4 and 5 require that the controller of an AI should be fit and proper on an ongoing basis. The current definition of controllers in BO section 2 is wide enough to cover indirect controllers and majority shareholder controllers of the holding company of an AI and therefore these controllers are also subject to BO Schedule 7 Paragraph 4 or 5.</p> <p>In the case of AIs incorporated in Hong Kong, approval from the MA is required for any changes of the controllers after authorization (BO section 70) and the approval will be granted only when the controllers, among other things, are fit and proper. The criteria used by the MA to determine the fitness and propriety of controllers are set</p>

	<p>out in the Authorization Guideline and the GTA Chapter 4.</p> <p>There is no statutory requirement that senior management of the controllers of AIs need individually to be fit and proper. However, BO section 70 empowers the MA to attach conditions to his consent for a party to become the controller of a locally incorporated AI. Therefore, the HKMA can use this as a means to enforce fit and proper standards for senior management of parent companies as and when necessary.</p> <p>As mentioned in EC 1, the MA's general policy is that a person who holds more than 50 percent of the share capital of a local AI should be a well established bank or other supervised financial institution in good standing in the financial community and with appropriate experience. In considering applications from persons who do not fulfill this requirement, the MA's primary concern will be to ensure that any risks that may be posed to the existing or proposed AI by the applicant, and any other members of the corporate group of which the applicant is a member, are understood and well contained. To achieve this, the MA may attach conditions to his consent for the applicant to be or to become a majority shareholder controller. In many cases, local AIs are subsidiaries of international banking groups, and hence the MA can rely on the home regulators to ensure the fitness and propriety of the senior management of these banking groups. Nevertheless, there are a few cases where no holding company of a local bank is either supervised by the MA or an overseas banking regulator.</p> <p><i>Fit and proper standards for owners of parent companies</i></p> <p>The MA's approval under BO section 70 is required for a person to become a controller of a local AI. Therefore, the MA's fit and proper criteria are applicable to owners of parent companies if such owners fall within the definition of controller under the BO, and enforced through the relevant approval process and ongoing supervision.</p> <p><i>Fit and proper standards for senior management of parent companies</i></p> <p>In general, the background and experience of the senior management are one of the factors to be considered by the MA in assessing the fitness and propriety of the holding companies as controllers of an AI.</p> <p>As mentioned in EC 2, the HKMA has in Q3 2013 implemented an enhanced framework for the consolidated supervision of banking groups. This framework is applicable to cases where no holding company of a local bank is a regulated entity. Under the enhanced framework, the conditions attached to the shareholder controller approval given under BO section 70 to the IHC of the AI include (i) prior consent requirement for appointment of the chief executive and director and (ii) compliance with corporate governance requirements. In determining whether to give prior written consent for the appointment of chief executive or director of IHC, the MA will consider whether the candidate is fit and proper as he would in the case of chief executive or director of the local bank.</p>
<b>Assessment of Principle 12</b>	Compliant.
<b>Comments</b>	The HKMA has a strong legal and regulatory framework for consolidated supervision that it applies in practice. The HKMA carefully monitors actual and potential risks across the entire group structure, placing emphasis on corporate governance and

	robust risk management policies and procedures. The HKMA analyzes AIs on both a solo and consolidated basis.
<b>Principle 13</b>	Home-host relationships. Home and host supervisors of cross-border banking groups share information and cooperate for effective supervision of the group and group entities, and effective handling of crisis situations. Supervisors require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks.
<b>Essential criteria</b>	
<b>EC1</b>	The home supervisor establishes bank-specific supervisory colleges for banking groups with material cross-border operations to enhance its effective oversight, taking into account the risk profile and systemic importance of the banking group and the corresponding needs of its supervisors. In its broadest sense, the host supervisor who has a relevant subsidiary or a significant branch in its jurisdiction and who, therefore, has a shared interest in the effective supervisory oversight of the banking group, is included in the college. The structure of the college reflects the nature of the banking group and the needs of its supervisors.
<b>Description and findings re EC1</b>	<p>The HKMA is a significant host authority, but is the home authority for only a few locally incorporated AIs that have material cross-border operations which are typically concentrated in Mainland China.</p> <p>For the groups where the HKMA is the home authority it uses existing bilateral arrangements with the respective host supervisors for information sharing and supervisory cooperation. For example, the HKMA and the China Banking Regulatory Commission (CBRC) organize operational-level meetings twice a year for staff involved in the supervision of the relevant institutions to exchange supervisory information and concerns. This is in addition to the semi-annual meetings held between the senior management of the two authorities. In the context of the supervision of locally incorporated AIs, the HKMA also fosters bilateral relationships with a number of overseas authorities.</p> <p>For one locally incorporated AI, which is a subsidiary of an international banking group but which has an extensive operational network in Asia, the HKMA is a de facto "intermediate home supervisor" of the AI (from the "downstream" perspective of the AI together with its overseas branches and overseas subsidiaries). In this role, the HKMA has organized regional supervisory college meetings for that AI. In determining the host supervisors to be included in the college, the HKMA took into account the risk profile and significance of the AI's operations in their respective jurisdictions. As a host supervisor, the HKMA participates in supervisory colleges for 29 banking groups with significant operations in HKSAR.</p>
<b>EC2</b>	Home and host supervisors share appropriate information on a timely basis in line with their respective roles and responsibilities, both bilaterally and through colleges. This includes information both on the material risks and risk management practices of the banking group <sup>34</sup> and on the supervisors' assessments of the safety and soundness of the relevant entity under their jurisdiction. Informal or formal arrangements (such as

<sup>34</sup> See Illustrative example of information exchange in colleges of the October 2010 BCBS Good practice principles on supervisory colleges for further information on the extent of information sharing expected.

	MOUs) are in place to enable the exchange of confidential information.
<b>Description and findings re EC2</b>	<p><i>HKMA as a home supervisor</i></p> <p>The HKMA, as a home supervisor, seeks to provide relevant information to the host supervisory authority. Such information will include overarching information the supervisory framework in HKSAR as well as specific firm related information including the HKMA's approach to consolidated supervision of the AI's overseas activities, comments on the AI's ownership and management as well as comments on the AI's financial position and asset quality and the control systems.</p> <p>When carrying out an on-site examination on an overseas subsidiary or office of a locally incorporated AI, the HKMA's examination team will, as a general practice, meet with the relevant host supervisor(s). The HKMA shares the on-site examination reports with the overseas supervisors.</p> <p><i>HKMA as a host supervisor</i></p> <p>The HKMA seeks to maintain regular contacts with the home supervisors whether through bilateral meetings, visits, or other forms of communication. Information exchanged may include examination findings, risk profile and adequacy of risk management system. Other information would be exchanged if seen as relevant and meeting the criteria of BO section 121 on gateways for exchange of information and protection of secrecy.</p> <p><i>Information sharing at supervisory colleges</i></p> <p>Within college settings, the HKMA typically shares its supervisory assessment of the AIs' risk profile and issues of its key supervisory focus.</p> <p>The HKMA has entered into MoUs or other formal arrangements with a number of overseas banking supervisory authorities (26 authorities in 22 jurisdictions) providing a framework for the sharing of information, arrangement of meetings as well as other informal contact and to provide that the authorities will consult each other regarding any cross-border establishment or investment by the banks. As noted in CP3, the HKMA is currently in the process of negotiating with further overseas banking authorities with a view to agreeing MoUs. The HKMA is mindful of the constraints of professional secrecy in all its exchanges and this is reflected in the MoUs themselves.</p> <p>The HKMA does not however regard an MOU as mandatory before information exchange can take place, providing such exchanges are in conformity with the BO. In such cases, the HKMA indicated that it endeavored to maintain close contacts and/or hold regular meetings with such supervisor if the operations of an AI or its banking group in their jurisdiction are material.</p> <p>In discussion with firms, it was clear that the HKMA followed up on issues that had arisen in college meetings with the AIs, although it was not practice to give feedback to firms as a matter of course.</p>
<b>EC3</b>	Home and host supervisors coordinate and plan supervisory activities or undertake collaborative work if common areas of interest are identified in order to improve the effectiveness and efficiency of supervision of cross-border banking groups.
<b>Description and findings re EC3</b>	The HKMA (acting either as a home or host supervisor) communicates its examination plan in respect of an AI to the relevant overseas supervisors. In particular the HKMA

	<p>and CBRC have arranged to share their plans for examination of locally incorporated AIs' branches and subsidiaries in Mainland China, reflecting the fact that most locally incorporated AIs' overseas operations are predominantly in Mainland China.</p> <p>In addition, the HKMA will share its supervisory plans with the home and other host supervisors as usual practice and seeks to collaborate with the home supervisors on common areas of interest. For example, the HKMA provided the risk assessment of the operations of a locally incorporated AI (which is part of an international banking group) to the home supervisor and participated in subsequent discussions regarding the consolidated risk assessment for the banking group concerned.</p>
<b>EC4</b>	<p>The home supervisor develops an agreed communication strategy with the relevant host supervisors. The scope and nature of the strategy reflects the risk profile and systemic importance of the cross-border operations of the bank or banking group. Home and host supervisors also agree on the communication of views and outcomes of joint activities and college meetings to banks, where appropriate, to ensure consistency of messages on group-wide issues.</p>
<b>Description and findings re EC4</b>	<p><i>HKMA as a home supervisor</i></p> <p>When acting as a home supervisor the HKMA focuses much attention on the CBRC, given the overseas operations of the locally incorporated AIs, of which the HKMA is a home supervisor, are predominantly in Mainland China reflecting the nature and extent of the activities of the HK banking sector. The HKMA seeks to ensure that consistent messages on group wide issues are identified and communicated to the banking groups. For one locally incorporated AI which maintains a banking subsidiary in Mainland China, the HKMA and CBRC have discussed and agreed on the issues of the group and possible remedial measures. The HKMA and CBRC have respectively communicated the identified weaknesses to the AI concerned and its Mainland banking subsidiary and asked for immediate rectification.</p> <p><i>HKMA as a host supervisor</i></p> <p>The HKMA is predominantly a host supervisor for cross-border banking groups. As host supervisor, the HKMA generally contributes to, supports and acts on the communication strategy developed by the home supervisor. Recent examples of coordination on the communication of views and outcomes of joint activities relate to the resolution planning requirements for, and resolution strategies for, G-SIBs, where the HKMA and the home authority have contributed to ensure consistency of messages delivered across the group.</p>
<b>EC5</b>	<p>Where appropriate, due to the bank's risk profile and systemic importance, the home supervisor, working with its national resolution authorities, develops a framework for cross-border crisis cooperation and coordination among the relevant home and host authorities. The relevant authorities share information on crisis preparations from an early stage in a way that does not materially compromise the prospect of a successful resolution and subject to the application of rules on confidentiality.</p>
<b>Description and findings re EC5</b>	<p>Globally, work on developing crisis management frameworks is still in its early phases but the HKMA has been an active participant in these initiatives.</p> <p>For example, the HKMA is a member (as a host authority) of the CMGs for nine global systemically important financial institutions (G-SIFIs). The HKMA is working closely with the home authorities to set up institution-specific cross-border cooperation</p>

	<p>agreements, defining roles and responsibilities pre-crisis and during a crisis as well as the relevant information sharing, coordination and cooperation processes, for the G-SIFIs concerned.</p> <p>The HKMA, as host authority, has had recent practical experience of cooperation and coordination with a home authority, with which it has a statement of cooperation, in successfully resolving a branch entity in HKSAR. Communication with the home authority took place from the outset of emerging stress in the branch and information flow covered the monitoring of problems, assessment of resolvability and development of an operational plan to merge the Hong Kong operations into that of an acquiring entity.</p> <p>The framework for information sharing and cooperation, as set out in existing MoUs and other formal arrangements entered into by the HKMA, are also being used as a basis to leverage cross-border crisis cooperation and coordination.</p> <p><i>HKMA as a home supervisor</i></p> <p>The HKMA is in the process of developing a local framework for RRP for AIs in HKSAR which is designed to meet the standards outlined in the “Key Attributes of Effective Resolution Regimes for Financial Institutions” (Key Attributes). In its industry consultation on the development of a local RRP framework for AIs, the HKMA has indicated that where the HKMA is the home regulator of an AI and its group, the HKMA will expect the AI’s RRP process to take account of the AI’s subsidiaries and branches, both local and overseas in a proportionate manner.</p> <p><i>HKMA as a host supervisor</i></p> <p>The HKMA has also indicated in its consultation on a local RRP framework that locally incorporated entities which are part of overseas banking groups will be expected to produce and submit recovery plans and provide further information and analysis to support resolution planning, to the HKMA. Some use of the group plan may be permitted if (i) the group plan provides adequately for, or is supplemented by sufficient additional information on, the recovery and orderly resolution of the Hong Kong operations and, (ii) the HKMA is given access to all relevant information in relation to the group plan. Ultimately, however, it is generally expected that AIs with significant operations in Hong Kong (including locally incorporated AIs which are part of the overseas banking groups as well as foreign incorporated AIs) will need to produce local recovery plans, dovetailed into their group plans, and provide the HKMA with sufficient information and analysis to support resolution planning. It was clear in discussion with firms that this understanding has been communicated to the industry.</p> <p>The HKMA has entered into a MoU (Resolution MoU) with an overseas authority. The Resolution MoU sets out the framework for the exchange of information in connection with the monitoring of firms; crisis management; RRP for, and the resolution of, troubled firms with cross border operations.</p> <p>Firms with whom the assessors met confirmed that where global RRPs existed for the wider group, there had already been locally based discussions with the HKMA.</p>
<b>EC6</b>	Where appropriate, due to the bank’s risk profile and systemic importance, the home

	<p>supervisor, working with its national resolution authorities and relevant host authorities, develops a group resolution plan. The relevant authorities share any information necessary for the development and maintenance of a credible resolution plan. Supervisors also alert and consult relevant authorities and supervisors (both home and host) promptly when taking any recovery and resolution measures.</p>
<p><b>Description and findings re EC6</b></p>	<p>The HKMA has been actively involved in group-level RRP for those G-SIBs which have a substantial presence in HKSAR. As with crisis management issues, international efforts on recovery and resolution are at an early stage.</p> <p>As a host supervisory authority, the HKMA has participated in a number of CMGs for G-SIFIs organized by the relevant home authorities to discuss and plan for cross-border crisis management, including the review of recovery plan and the development of resolution plan for each of these institutions in accordance with the principles established by the FSB. As a home and host authority the HKMA has engaged in active discussions with AIs on the group resolution plans, as confirmed by the assessors in discussion with firms.</p> <p><i>Local RRP Framework</i></p> <p>The HKMA is in the process of setting up a local framework for RRP for AIs in HKSAR designed to meet the standards outlined in the FSB's Key Attributes. The HKMA November 2012 consultation on RRP in Hong Kong indicated that where the HKMA is the home regulator of an AI and its group, it will expect the AI's recovery plan to be group-wide. Under the HKMA proposals all locally incorporated subsidiaries of overseas banking groups will be expected to produce and submit local recovery plans to the HKMA.</p> <p>It is planned that some use of group plans may be permitted (to minimize duplication and cost) but this will only be the case where (i) the HKMA is given access to all relevant information by the group in respect of the recovery plan and by the home supervisor in respect of the resolution plan, and (ii) the plan provides adequately for, or is supplemented by sufficient additional information on, the recovery and orderly resolution of the Hong Kong operations. In practice, however, it is generally expected that AIs with significant operations in Hong Kong (including locally incorporated AIs which are part of the overseas banking groups as well as foreign incorporated AIs) will produce local recovery plans, dovetailed into their group plans, and provide the HKMA with sufficient information and analysis to support resolution planning. The HKMA note that branch entities are likely to have to rely to a considerable extent on group level planning and actions.</p> <p>The HKMA issued an SPM module on recovery planning for consultation in November 2013. Systemically important AIs will be expected to submit recovery plans within 6 months of the finalization of the SPM module.</p> <p><i>Exchange of information via MoUs</i></p> <p>Existing MoUs have been fit for purpose in the context of resolution experiences, for example in the financial crisis, though the HKMA has recently entered into a specific Resolution MoU with an overseas authority. The HKMA will consider the need to amend existing, or enter into further, MoUs or other formal arrangements to</p>



	strengthen the basis of home-host coordination for resolution related issues where necessary.
<b>EC7</b>	The host supervisor's national laws or regulations require that the cross-border operations of foreign banks are subject to prudential, inspection and regulatory reporting requirements similar to those for domestic banks.
<b>Description and findings re EC7</b>	<p>The prudential requirements and supervisory approach applied to branches and subsidiaries of foreign banks in HKSAR are broadly the same as those applied to locally incorporated AIs. All AIs are subject to periodic on-site examinations, off-site reviews, prudential meetings, tripartite meetings and statutory reporting obligations (i.e. banking returns, supplementary information as required and external auditors' reports under (BO see sections 63 and 59).</p> <p>Minimum authorization criteria under the BO Schedule 7 are applicable to all AIs, including those on the identity of each controller, fitness and propriety of each director, controller and chief executive, adequate systems of control for the appointment of managers, adequate liquidity, adequate provisioning, adequate accounting systems and systems of control and prudent and competent conduct of business.</p> <p>Foreign bank branches are however not required to hold capital or observe capital adequacy requirements in HKSAR, given that the responsibility for supervising the overall capital adequacy of foreign banks rests with their home supervisors and that the branch does not have a separate legal identity from its parent. Branches are also exempt from the statutory limits on exposures and concentration of risks covering: large exposures, connected lending, holding of shares and interest in land etc. Such items must, however, be reported to the HKMA and are monitored, so that the HKMA can contact the home supervisory authority in event of concern. However, under BO Schedule 7, the MA will need to be satisfied on authorization and thereafter that they meet, inter alia, the authorization criteria related to adequate financial resources.</p> <p><i>Supervisory approach</i> The HKMA applies its risk based supervisory approach consistently across all AIs, including both locally incorporated AIs and overseas incorporated AIs.</p> <p>While foreign branches in HKSAR are not subject to capital ratio requirements and capital-based limits on large exposures and concentration of risk, the HKMA reviews the capital adequacy of the overseas incorporated AIs at entity level in the annual CAMEL review process.</p> <p><i>On-site examination</i> The frequency of on-site risk based examinations for overseas incorporated AIs may be less than that for local banks, depending on such factors as:</p> <ul style="list-style-type: none"> <li>• the overall financial strength and internal control adequacy;</li> <li>• the systemic impact of its failure to the banking system of HKSAR;</li> <li>• the adequacy of home supervision;</li> <li>• the frequency of inspections of the HKSAR operations by the home supervisors or head office internal audit.</li> </ul>

	<p>In general, for overseas incorporated AIs, the frequency of on-site risk-based examinations is generally once every four to five years, though can be increased to annually if warranted due to a composite CAMEL rating of 3 or worse. Thematic and specialized examinations apply to local and foreign incorporated AIs.</p> <p><i>Off-site surveillance</i></p> <p>All AIs are subject to a comprehensive annual off-site CAMEL review. Both locally incorporated AIs and foreign branches are subject to similar reporting requirements, though foreign branches are not required to submit capital adequacy returns. Similarly, foreign branches are not required to submit returns related to liquidity stress testing on the basis that their liquidity risk is usually managed on an integrated global basis with stress testing being conducted at regional or group level. The HKMA pays close regard to capital strength of the parent, and monitors the liquidity ratio for branches. Liquidity stress testing is applied to overseas incorporated AIs which have retail business in HKSAR.</p> <p>At the time of the assessment, the HKMA was in the process of enhancing its supervisory liquidity stress testing framework by incorporating larger branches of foreign banks. Separately, the HKMA reviews the internal stress testing approach of some overseas incorporated AIs in the on-site examination.</p>
<b>EC8</b>	<p>The home supervisor is given on-site access to local offices and subsidiaries of a banking group in order to facilitate their assessment of the group's safety and soundness and compliance with customer due diligence requirements. The home supervisor informs host supervisors of intended visits to local offices and subsidiaries of banking groups.</p>
<b>Description and findings re EC8</b>	<p>As part of the approval process of a foreign branch or subsidiary for a locally incorporated bank, one of the HKMA's considerations is whether there are any restrictions on the exchange of information, such as secrecy constraints that would inhibit effective consolidated supervision.</p> <p>The HKMA conducts regular visits and on-site examinations to overseas branches and subsidiaries of locally incorporated AIs and it is normal practice to notify the host supervisor in advance. In addition, the HKMA usually meets with the host supervisor during the visits / examination.</p> <p>The HKMA has never been impeded from conducting on-site examinations of an AI's foreign banking operations (whether a foreign branch or subsidiary). Were an impediment to arise, the MA would consider the extent to which the operations may potentially pose a threat to the AI and the need to require the AI to cease conducting business in the jurisdiction concerned by exercising powers under the BO, namely sections 49, 51A and 52 relating to revocations and restrictions.</p> <p>Subject to the requirements of BO (section 68), overseas authorities have access to and may carry out on-site inspection on banks in HKSAR. Meetings between the HKMA and the overseas examiners are normally held before and after the examination to exchange views on the financial condition and internal control systems of AIs examined and follow up on the issues or concerns identified by the overseas</p>

	examiners.
<b>EC9</b>	The host supervisor supervises booking offices in a manner consistent with internationally agreed standards. The supervisor does not permit shell banks or the continued operation of shell banks.
<b>Description and findings re EC9</b>	No shell bank exists in HKSAR, and there is no AI which operates solely as a booking office with no meaningful mind and management. It is HKMA policy that no authorization will be granted to any shell banks or booking offices.
<b>EC10</b>	A supervisor that takes consequential action on the basis of information received from another supervisor consults with that supervisor, to the extent possible, before taking such action.
<b>Description and findings re EC10</b>	It is HKMA practice to give prior notification to relevant overseas supervisors regarding any significant supervisory actions (such as any restrictive measures which might affect the business operations of AIs) it is about to take against AIs. This covers situations where the need for supervisory action arises from information received from overseas supervisors. MoUs or other formal cooperation arrangements may include the agreement to endeavor to notify each other to the extent it is possible, prior to taking remedial action.
<b>Assessment of Principle 13</b>	Compliant
<b>Comments</b>	<p>HKSAR is a major international financial center and the HKMA is a significant host jurisdiction, which puts a premium on the quality of home-host supervisory relationships. The HKMA participates in supervisory colleges and seeks to foster close bilateral relationships with key home state supervisors. Importantly, the HKMA is conscious of the need to continue developing relationships and evolving modes of communication and shared analysis for cross border groups.</p> <p>In respect of resolution planning, the HKMA is very active with the relevant home authorities and individual institutions in relation to the position of HKSAR entities within group resolution plans even though the domestic resolution regime is not yet in place.</p>
<b>Principle 14</b>	Corporate governance. The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organizational structure, control environment, responsibilities of the banks' Boards and senior management, <sup>35</sup> and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the bank.
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor establish the responsibilities of a bank's Board and senior management with respect to corporate governance to ensure there is effective control over the bank's entire business. The supervisor provides guidance to banks and banking groups on expectations for sound corporate governance.
<b>Description and findings re EC1</b>	In furtherance of the MA's principal function under the BO of promoting the general stability and effective working of the banking system, the MA has a strong interest in ensuring there is effective corporate governance within AIs. The HKMA sets out the

<sup>35</sup> Please refer to footnote 27 under Principle 5.

	<p>minimum standards that it expects locally incorporated AIs to adopt in respect of corporate governance in SPM CG-1 “Corporate Governance of Locally Incorporated Authorized Institutions.”</p> <p>SPM CG-1 section 2 sets out the key responsibilities of the Board and senior management of an AI with respect to corporate governance as follows:</p> <p><i>Key responsibilities of the Board</i></p> <ul style="list-style-type: none"> <li>• setting and overseeing the objectives of the AI and the strategies for achieving those objectives;</li> <li>• risk governance, including the approval and regular review of the AI’s overall risk strategy (including a risk appetite / tolerance) and key risk management policies;</li> <li>• appointment and oversight of senior management;</li> <li>• setting corporate values and standards covering ethical and professional behavior and conflicts of interest;</li> <li>• ensuring a suitable and transparent corporate structure;</li> <li>• ensuring effective internal and external audit functions; and</li> <li>• ensuring an appropriate degree of transparency in respect of the structure, operation and risk management of the AI.</li> </ul> <p><i>Key responsibilities of senior management</i></p> <ul style="list-style-type: none"> <li>• implementing the business and risk strategies approved by the Board;</li> <li>• formulating detailed policies, procedures and limits for managing different aspects of risk arising from the AI’s business activities, based on the risk management strategy, risk tolerance/appetite and policies established and approved by the Board;</li> <li>• ensuring that the risk management and internal control systems work as intended;</li> <li>• putting in place processes for reviewing the AI’s risk exposures and ensuring that they are kept within the risk limits set, and that those limits are consistent with the AI’s overall risk appetite, even under stress conditions;</li> <li>• establishing an effective management information system to report to the Board and senior management in a format fit for their respective use, on a timely basis; and</li> <li>• ensuring the competence of the managers and staff responsible for the business, internal control and risk management functions of the AI, with appropriate programs to recruit, train and retain employees with suitable skills and expertise.</li> </ul> <p>SPM CG-1 also provides guidance on sound corporate governance in the following aspects:</p> <ul style="list-style-type: none"> <li>• organization and functioning of the Board (section 3);</li> <li>• board composition and appointment of directors (sections 4 and 5)</li> <li>• board qualification and training and Board performance evaluation (sections 6</li> </ul>
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	<p>and 7);</p> <ul style="list-style-type: none"> <li>• sound corporate governance in the context of an AI within a banking group (section 8).</li> </ul> <p>Further guidance on the risk governance responsibilities of the Board and senior management of AIs is set out in SPM IC-1 “General Risk Management Controls” section 2 and SPM IC-2 “Internal Audit Function” sections 2.2 and 2.3.</p> <p>The HKMA has established that the primary responsibility for the prudent management of an AI to ensure its safety and soundness rests with its Board and senior management. In this connection, the HKMA has made it clear in its communications with the banking industry (through meetings, circulars, issuance of SPMs, etc.) that effective corporate governance in an AI is of paramount importance as it represents the manner in which the business and affairs of AIs are directed and managed by their Board and senior management.</p> <p>SPM CG-1 was revised and reissued on 3 August 2012 with a view to strengthening the guidance provided to, and the requirements imposed upon, AIs by reference to new international standards developed in response to the lessons of the global financial crisis, including in particular the Basel Committee on Banking Supervision’s “Principles for enhancing corporate governance” (October 2010). The HKMA clearly communicated its expectation that AIs should take all necessary steps (e.g., identify gaps and implement plans for enhancing their corporate governance frameworks) to bring their corporate governance policies and practices into line with the revised SPM CG-1 within 12 months from the date of the issuance of the revised SPM module (i.e. on or before 3 August 2013).</p> <p>The HKMA has closely monitored AIs’ progress in relation to the implementation of the standards in the revised SPM module. This included obtaining and reviewing a gap analysis conducted by AIs, as well as their implementation schedules and action plans. Board minutes were also reviewed to determine the extent of discussion among an AI’s Board members on the AI’s plans and actions in aligning its corporate governance framework to that described in the SPM module. At the end of the 12-month implementation period, the HKMA commenced a desktop stock-take review to ensure locally incorporated AIs satisfy the requirements set out in the revised SPM module.</p> <p>On 30 August 2012 the HKMA issued a circular entitled “Training for Directors of Locally Incorporated Authorized Institutions” requesting locally-incorporated AIs to complete a survey on the training being made available to directors. Given the results of the survey, the HKMA has recently established an advisory group, chaired by an Executive Director of the HKMA and comprising representatives of the Hong Kong Institute of Bankers and a number of respected individuals connected with the industry. The roles of the group are to:</p> <ul style="list-style-type: none"> <li>• advise the industry on the topics that should be included in induction and continuing development programs for directors of AIs;</li> <li>• outline the types of activity that may be counted as training and continuing development (e.g., classroom training, internal briefings on regulatory</li> </ul>
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	<p>developments, participation in relevant discussion forums, publishing articles), the preferred format and delivery channels for such programs, and the need for a structured evaluation mechanism; and</p> <ul style="list-style-type: none"> <li>• facilitate, where necessary, the provision of centralized development programs to ensure relevant assistance is made available and a degree of consistency in what is offered.</li> </ul> <p>The advisory group will serve to strengthen and enhance the means for the development of directors so as to better equip them to perform their role and thereby improve the corporate governance of AIs.</p>
<b>EC2</b>	<p>The supervisor regularly assesses a bank's corporate governance policies and practices, and their implementation, and determines that the bank has robust corporate governance policies and processes commensurate with its risk profile and systemic importance. The supervisor requires banks and banking groups to correct deficiencies in a timely manner.</p>
<b>Description and findings re EC2</b>	<p>SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" makes it clear that AIs are expected to maintain a level of corporate governance reflective of the standards set out in SPM CG-1 in a manner commensurate with the nature, scale and complexity of their operations.</p> <p>The HKMA's supervisory processes for evaluation of the corporate governance policies and practices of an AI are set out in SPM CG-1 section 10.</p> <p>The HKMA assesses the adequacy of an AI's corporate governance policies, practices and their implementation in its ongoing risk-based supervisory process, including the annual off-site review, regular on-site examinations and meetings with the Board, Board-level committees and senior management of the AI. An AI is expected to maintain robust corporate governance commensurate with its risk profile and systemic importance. The assessments mentioned below on the adequacy of AIs' corporate governance take into account the nature, scale and complexity of their operations.</p> <p><i>Annual off-site review</i></p> <p>In the annual off-site review, a CAMEL rating review and, for locally incorporated AIs, a Pillar 2 Supervisory Review Process (SRP) are conducted. In the CAMEL rating review, "Compliance with the Guideline on Corporate Governance" is one of the assessment factors of the Management component. In the Pillar 2 SRP, the AI's corporate governance is one of the assessment scorecards.</p> <p>All relevant information relating to corporate governance of the AI noted in the course of day-to-day off-site surveillance and on-site examinations are taken into account in the CAMEL rating review and Pillar 2 SRP. The HKMA also requests the AI under review to produce up-to-date information on its corporate governance policies and practices and their implementation, including:</p> <ul style="list-style-type: none"> <li>• the mandate of the Board and the terms of reference of the Board-level specialized committees and management level committees</li> <li>• information packs for, and attendance record and minutes of, Board meetings</li> </ul>

	<p>and the meetings of Board-level committees</p> <ul style="list-style-type: none"> <li>• Board-level committees' reports to the full Board and the regular reports of the AI's risk control functions to the Board and Board-level committees</li> <li>• internal audit reports, external audit reports and management letters from external auditors together with the management response</li> <li>• Board performance evaluation reports</li> </ul> <p>The HKMA also takes "development activities" undertaken by directors, chief executives and alternate chief executives into account in assessing the quality of AIs' corporate governance for the purposes of the SRP and CAMEL rating review. To facilitate this, directors of an AI are required to submit to the AI records of the training, development and other activities they have participated in during the preceding year. This may include activities organized by the AI or external providers and activities undertaken by individual directors as part of their relevant professional development. The AI then submits to the HKMA a summary record of these activities for each director no later than one month after the end of each calendar year for the HKMA's review.</p> <p>The HKMA also communicates with the AI's senior management, risk management, internal audit and compliance functions from time to time to keep abreast of the AI's corporate governance framework and to assess the robustness and effectiveness of the framework.</p> <p><i>On-site examinations</i></p> <p>The HKMA conducts on-site examinations to assess the adequacy and effectiveness of the Board and senior management oversight of an AI's risk management processes based on the standards and requirements set out in the relevant guidelines.</p> <p>Areas of on-site examination coverage may include, among others, whether the Board of the AI has actively played its role in overseeing the operations and financial soundness of the institution, and whether various business, financial operation, risk and control issues are reviewed and discussed at the Board's regular meetings. The results of on-site examinations would be used as input to the annual off-site review.</p> <p><i>Assessment through direct meeting with Board members</i></p> <p>The HKMA periodically meets with an AI's Board, Board-level committees (e.g., audit committee and risk management committee) and senior management to understand the AI's financial performance, financial position, corporate governance structures policies and practices, risk management practices, and internal controls and processes, as well as to discuss of any major supervisory concerns noted. While such meetings help to enhance the communication between the Board and the HKMA on issues of mutual concern regarding the AI, they also provide the HKMA with an opportunity to obtain a first-hand understanding of the attitude and style of management of the Board and senior management of the AI, thus helping the HKMA in assessing the effectiveness of the Board and senior management in overseeing the operations of the AI.</p> <p>Any deficiencies in an AI's corporate governance identified in the HKMA's supervisory</p>
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	<p>process are raised to the AI's senior management and, where necessary, the Board or Board-level committees. The HKMA requires the AI to take timely remedial action. In the meantime, any adverse corporate governance issues are reflected in the annual CAMEL rating review and Pillar 2 SRP. It is the general practice of the BSD CAMEL rating process to attach paramount importance to the "management" component. A downgrade of this component, e.g., due to poor corporate governance, will trigger a review to assess if downgrade of the Composite Rating is required. A downgrade of the AI's CAMEL rating or an increase in its Pillar 2 capital charge can serve as supervisory tools to incentivize the AI to rectify the deficiencies identified in a timely manner.</p> <p>In the recent past, actions have been taken by AIs to enhance their risk governance. For instance, a number of AIs set up Board-level risk management committees (or segregated their former "Audit and Risk Committee" into two separate committees) upon the HKMA's communication with management and as a result of the issuance of the revised SPM CG-1, which encouraged AIs to establish a Risk Management Committee in which all, or the majority, of the members should be non-executive directors.</p>
<b>EC3</b>	<p>The supervisor determines that governance structures and processes for nominating and appointing Board members are appropriate for the bank and across the banking group. Board membership includes experienced non-executive members, where appropriate. Commensurate with the risk profile and systemic importance, Board structures include audit, risk oversight and remuneration committees with experienced non-executive members</p>
<b>Description and findings re EC3</b>	<p>SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" sections 3 to 6 set out supervisory guidance on the governance structures and processes for the nomination and appointment of directors, Board membership and Board committees.</p> <p><i>Nomination and appointment of Board members</i></p> <p>SPM CG-1 Paragraph 5.1.1 specifies that the Board, or any nomination committee of the Board, should identify and select qualified and experienced candidates for appointment as director in accordance with formal policies and procedures established by the Board on the selection and appointment/re-appointment process. If an AI is a wholly-owned subsidiary of a holding company, the nomination and appointment of the AI's Board members may be performed by the nomination committee of the AI's holding company if the HKMA is satisfied that certain conditions are met.</p> <p>The policies for selection of directors should include a description of the necessary competencies and skills required to ensure sufficient expertise. Moreover, the Board should satisfy itself that the candidate for appointment is a fit and proper person for the appointment, taking account of his or her experience.</p> <p>In reviewing AIs' compliance with the SPM module CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" in relation to appointment of directors, the HKMA reviews AIs' procedures and processes for nominating and appointing directors, and the composition and duties of the nomination committee, taking into</p>



	<p>account the AI's risk profile and systemic importance.</p> <p>AIs are expected to inform the HKMA whenever there is any change in the composition of the nomination committee; the HKMA will assess the implication of the change for the composition and independence of the committee.</p> <p>The HKMA considers that the adequacy of an AI's governance structures and processes for nominating and appointing Board members is also reflected in the appropriateness of the person to be nominated and appointed to the Board or who has been nominated and appointed. If an applicant to become a director, or an existing director, is assessed not to be appropriate (in terms of fitness and propriety, conflict of interest, expertise, etc.), the HKMA will review whether the relevant facts leading to the assessment were available at the time when the director in question was nominated and whether the facts had been thoroughly considered. If so, the HKMA has ground to question the governance structures and processes of the AI in its nomination and appointment of Board members. While the HKMA would communicate its comments / views to the AI on the appropriateness of nominating and appointing the particular person concerned, the HKMA would, if it deems fit, also initiate a review to evaluate the whole nomination and appointment process of the AI to identify any areas of weakness.</p> <p>To enable the HKMA to make a better assessment in the course of its approval process for applicants for appointment as directors of AIs, the HKMA, when it considers that it is appropriate, conducts a face-to-face meeting with the candidate. This allows the HKMA to assess first-hand the candidate's personal qualities, skills, knowledge and understanding of the AI's business and key regulatory and supervisory requirements and whether he or she will be able to fulfill adequately the role for which he or she is being considered. (See also Principle 5 EC 6 on the evaluation of the fit and proper criteria for directors / chief executives / alternate chief executives of an AI.)</p> <p><i>Board membership</i></p> <p>SPM CG-1 Paragraph 6.1 specifies that the Board, both as individual Board members and collectively, should possess appropriate experience, competencies and personal qualities, including professionalism and integrity, to discharge its responsibilities adequately and effectively.</p> <p>In addition to experience and expertise, an AI's Board should have an adequate number, and appropriate composition, of members to ensure sufficient independence. In general, either three or one-third of the Board members, whichever is higher, of a locally incorporated licensed bank should be independent non-executive directors. In the case of smaller locally incorporated AIs, while the HKMA strongly encourages them to appoint at least three independent non-executive directors, the HKMA recognizes that this may not be realistic and, in such cases, the HKMA expects them to include an appropriate number of independent, or at least non-executive, directors on their Board. What is "appropriate" will vary on a case-by-case basis, depending on factors such as the size of the AI and the total number of directors on its Board.</p> <p>The HKMA reviews the composition of the Board and the Board-level committees</p>
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(such as the Audit Committee, Risk Management Committee and Remuneration Committee) as well as their roles and responsibilities as part of its on-going supervisory process to ensure that all locally incorporated AIs meet, or are working satisfactorily towards meeting, the expected standards on corporate governance.

Such review is to ensure the Board, and each Board-level specialized committee, are made up of appropriate mixes of executive directors, non-executive directors and independent non-executive directors (INED), and an appropriate mix of directors in terms of experience and skills that can benefit the AI. Such review is carried out at least once every year when the HKMA conducts the annual off-site review of an AI. The assessment is conducted again once there is any new appointment, resignation or redesignation of directors leading to a change in the composition of the Board or in the Board-level specialized committees.

#### *Board committees*

The Board should appoint members to specialized committees with the goal of achieving an optimal mix of skills and experience that, in combination, allows the committees to fully understand, and objectively evaluate the relevant issues. In order to achieve the needed objectivity, the committees should have in their membership a sufficient number of independent directors. Specific requirements on the membership of key Board committees are summarized below:

- each locally incorporated licensed bank should have a nomination committee chaired by the chairman of the Board or by an independent non-executive director. The majority of its members should be independent non-executive directors. Locally incorporated restricted license banks and DTC are strongly encouraged to establish similar committees;
- each locally incorporated AI should have an audit committee that should be made up of non-executive directors, the majority of whom, including the chairman, should be independent;
- each locally incorporated AI, particularly each licensed bank, is strongly encouraged to have a risk management committee with all, or the majority, of its members being non-executive directors;
- each locally incorporated licensed bank should have a remuneration committee comprising independent non-executive directors or, where executive directors are to be members of the committee, comprising a majority of independent non-executive directors. Locally incorporated restricted license banks and DTC are strongly encouraged to establish similar committees.

#### *Board performance evaluation*

The Board is also expected to conduct regular assessments of the effectiveness of the Board as a whole and the contribution made by each individual director to the effectiveness of the Board, to determine if the Board or its committees collectively lack any skills or expertise to discharge their responsibilities effectively, and to identify steps for improvement. Where the performance of individual Board members does not meet expectation or there is serious concern on a member's integrity, the Board is required to take appropriate action.

	The HKMA also collects and reviews, the results of any Board performance evaluation undertaken by the AI as encouraged by SPM CG-1 (section 7) to assess, among other things, whether the AI has put in place robust governance structure and procedures in the nomination and appointment of Board members.
<b>EC4</b>	Board members are suitably qualified, effective and exercise their “duty of care” and “duty of loyalty.” <sup>36</sup>
<b>Description and findings re EC 4</b>	<p>The MA ensures the fitness and propriety of the directors of an AI on and after authorization by means of his power under BO section 71 which, among other things, provides that no person shall become the director of a locally incorporated AI without the consent in writing of the MA or act or continue to act as such director after the consent of the MA has been withdrawn. In order to obtain the consent or avoid the withdrawal of the consent, the person concerned should be fit and proper (BO section 71(2)).</p> <p>The fitness and propriety of directors also constitutes one of the minimum criteria that should be satisfied in order for a company to become an AI in Hong Kong (BO Schedule 7 Paragraphs 4 and 5).</p> <p>The fit and proper requirements are elaborated in the Authorization Guideline and the GTA Chapter 4, which require, among other things, the person who will become a director to have appropriate knowledge and experience, competence, soundness of judgment and diligence (GTA Paragraph 4.19). These factors are also reiterated in SPM CG-1 Paragraph 6.1. Moreover, the HKMA requires the directors and the Board to meet the following requirements:</p> <ul style="list-style-type: none"> <li>• the directors should act bona fide in the interest of the AI (i.e. duty of loyalty), and on an informed and prudent basis (i.e. duty of care), in accordance with applicable laws and regulations and supervisory standards;</li> <li>• the Board, in discharging its responsibilities, should take into account the legitimate interests of shareholders, depositors and other relevant stakeholders (i.e. duty of loyalty); and</li> <li>• the Board should ensure that persons to be appointed as directors are able to commit sufficient time and effort to fulfill their responsibilities effectively so that they can contribute actively to the work of the Board.</li> </ul> <p>The HKMA is of the view that it is good practice for the Board to undertake regular assessments of the effectiveness of the Board as a whole and the contribution made by each individual director to the effectiveness of the Board.</p>

<sup>36</sup> The OECD (OECD glossary of corporate governance-related terms in “Experiences from the Regional Corporate Governance Roundtables”, 2003, [www.oecd.org/dataoecd/19/26/23742340.pdf](http://www.oecd.org/dataoecd/19/26/23742340.pdf).) defines “duty of care” as “The duty of a board member to act on an informed and prudent basis in decisions with respect to the company. Often interpreted as requiring the board member to approach the affairs of the company in the same way that a ‘prudent man’ would approach their own affairs. Liability under the duty of care is frequently mitigated by the business judgment rule.” The OECD defines “duty of loyalty” as “The duty of the board member to act in the interest of the company and shareholders. The duty of loyalty should prevent individual board members from acting in their own interest, or the interest of another individual or group, at the expense of the company and all shareholders.”

	<p>Refer to EC 3 above for a discussion of the legal and supervisory requirements on Board members' integrity and qualification, and to Essential Criterion 6 for the assessment criteria of fitness and properness of an individual.</p> <p>Before granting authorization to an AI, the HKMA ensures that its directors and chief executive are fit and proper to hold their position based on the fitness and propriety criteria set out in the GTA. In the case of locally incorporated AIs, the MA has also to formally approve the appointment of the directors at the time of authorization and, thereafter, any new appointments also need to have the MA's approval under BO section 71. All these applications are processed by the Licensing Team which is a specialized unit in the Banking Conduct Department of the HKMA. (Please see Principle 5 EC 7 on the evaluation of the fitness and propriety criteria of applicant for directors of an AI.)</p> <p>To enable the MA to consider whether a proposed candidate for appointment to a locally incorporated AI's Board is fit and proper to carry out his or her duties, the MA, where he considers it appropriate, conducts a face-to-face meeting with the candidate. The face-to-face meeting is one of the new initiatives recently introduced by the HKMA with a view to enhancing the corporate governance of AIs.</p> <p>The HKMA also seeks to evaluate the effectiveness of the Board and Board members of an AI in the course of its ongoing supervision of the AI (via off-site review and on-site examinations).</p> <p>In assessing whether an applicant seeking the MA's approval to become a director of an AI is fit and proper, the HKMA considers a wide range of factors to make the assessment. The factors, to a large extent, ensure an applicant who can pass the test possesses qualities relative to "duty of care" and "duty of loyalty." For instance, a fit and proper candidate should demonstrate soundness of judgment and diligence, he should have no record of dishonesty, incompetence or malpractice, etc. In the case of an independent non-executive director, he should have no direct or indirect financial or other interests in the business of the AI concerned.</p> <p>In the course of its ongoing supervision, the HKMA keeps in view any incidents or issues indicating any possible breach of duty of care or loyalty or any conflict of interest on the part of individual Board members, or any other deficiencies identified that may cast doubt on the effectiveness of the Board. When such incidents occur or deficiencies are identified, the HKMA will make further enquiry of the AI concerned and require the AI to take remedial action where necessary.</p>
<b>EC5</b>	<p>The supervisor determines that the bank's Board approves and oversees implementation of the bank's strategic direction, risk appetite<sup>37</sup> and strategy, and related policies, establishes and communicates corporate culture and values (e.g.,</p>

<sup>37</sup> "Risk appetite" reflects the level of aggregate risk that the bank's Board is willing to assume and manage in the pursuit of the bank's business objectives. Risk appetite may include both quantitative and qualitative elements, as appropriate, and encompass a range of measures. For the purposes of this document, the terms "risk appetite" and "risk tolerance" are treated synonymously.

	through a code of conduct), and establishes conflicts of interest policies and a strong control environment.
<b>Description and findings re EC5</b>	<p>The responsibilities of the Board of an AI in respect of the items mentioned in this EC are set out in SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions", SPM CG-3 "Code of Conduct", SPM CG-6 "Competence and Ethical Behavior", SPM SR-1 "Strategic Risk Management" and SPM IC-1 "General Risk Management Control" and include:</p> <ul style="list-style-type: none"> <li>• setting and overseeing the objectives and overall strategy of the AI within the applicable legal and regulatory framework;</li> <li>• ensuring the AI's objectives and strategic goals are in line with the AI's corporate mission and values, culture, business direction and risk tolerance;</li> <li>• approving business and strategic plans for achieving the AI's objectives and ensuring that performance is regularly reviewed against the plans;</li> <li>• approving and establishing an overall risk strategy, including a clearly articulated risk tolerance / appetite, for the AI and monitoring adherence to the AI's risk appetite;</li> <li>• approving key risk management policies and overseeing management in developing policies and practices to manage risk in accordance with the Board's strategy and the AI's risk tolerance/appetite;</li> <li>• setting and communicating corporate values and standards throughout the AI by means of a code of conduct to promote ethical and responsible professional behavior amongst the AI's staff (including senior management and Board members);</li> <li>• ensuring that a culture of competence and ethical behavior is embedded within the AI at both the firm and individual staff levels;</li> <li>• establishing, implementing and maintaining effective policies to identify, prevent (where possible) and manage actual and potential conflicts of interest;</li> <li>• creating a strong corporate and risk management culture and establishing an organization and management structure with a sound control environment, adequate segregation of duties and clear accountability and lines of authority, and ensuring that the internal audit function of the AI is effective in performing an independent assessment of the adequacy of internal control systems covering all relevant risks of the AI; and</li> <li>• as good practice, undertaking regular assessments of the effectiveness of the Board as a whole and the contribution made by each individual director to the effectiveness of the Board.</li> </ul> <p>The HKMA determines whether an AI's Board approves and oversees implementation of the AI's strategic direction, risk appetite and strategy, and related policies through its ongoing supervisory work.</p> <p>AIs are required to submit their codes of conduct and any subsequent revisions to the HKMA. Once received, the HKMA reviews the AI's code of conduct taking into account the AI's risk profile, structure, size and business operations. The HKMA also collects and reviews documents such as Board minutes to ascertain that the code of conduct is reviewed and approved by the Board of the AI. Through reviewing the Board minutes and minutes of Board-level / senior management-level specialized committees, the</p>

	<p>HKMA assesses how the Board disseminates corporate culture and values to all levels of the AI and assesses whether, and the extent to which, the AI's senior management has likewise sought to ensure that the culture and values are embedded throughout the AI's organization.</p> <p>For the purpose of avoiding conflicts of interest and maintaining a strong control environment, an AI is expected to establish an organization structure with proper segregation of duties, an independent risk management function commensurate with the scale and complexity of its operations and its risk profile, an adequate compliance function, as well as an independent internal audit function. The HKMA regularly reviews AIs' organization structures and continually monitors the adequacy and effectiveness of the risk management, compliance and internal audit functions in the course of ongoing supervision.</p>
<b>EC6</b>	The supervisor determines that the bank's Board, except where required otherwise by laws or regulations, has established fit and proper standards in selecting senior management, maintains plans for succession, and actively and critically oversees senior management's execution of Board strategies, including monitoring senior management's performance against standards established for them.
<b>Description and findings re EC6</b>	<p>According to SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" Paragraph 2.5.4, the Board of an AI is responsible for the appointment and removal of the senior management of the AI and should ensure that the persons appointed are fit and proper to administer the AI's affairs and manage the AI's key business, internal control and risk management functions. Moreover, SPM CG-2 "Systems of Control for the Appointment of Managers" requires AIs to have systems of control for the appointment of managers, including defined policies and procedures for selection and appointment of managers and for determining the fitness and propriety of candidates for managerial positions.</p> <p>In general, the AI's Board defines which job positions are regarded as senior positions and what fit and proper qualities an individual should possess to undertake a particular senior role. While the Board appoints, and monitors the performance of, the chief executive of the AI, it delegates the responsibility for, and will oversee the chief executive of the AI in, setting up a system of control to closely monitor the appointment and performance of other senior managers for the purpose of ensuring that they possess and continue to possess the requisite fit and proper qualities for holding their positions.</p> <p>In the course of its off-site supervision or on-site examination, the HKMA verifies the adequacy of the AI's system of control for appointment of managers. This includes (i) reviewing Board minutes to assess whether the Board members are playing an active role in establishing the fit and proper standards for senior management, and whether they are overseeing the chief executive's work in appointing, and monitoring the performance of, other senior management to ensure they fulfill the fit and proper standards on a continual basis; (ii) reviewing the reasonableness of the fit and proper qualities established by the Board for each senior position; (iii) collecting the resumes of senior management and comparing them with the fit and proper qualities established by the Board, with a view to ensuring that the system of control is being</p>

	<p>effectively operated.</p> <p>The results of these assessments are taken into account in the HKMA's annual CAMEL rating review (principally the rating on the "Management" component) of AIs and in the Pillar 2 Supervisory Review Process for locally incorporated AIs. When any concern over the fitness and propriety of the chief executive or a manager, or any concern over the adequacy of the system of control for manager appointment, is identified, the HKMA will investigate and, if necessary, consider supervisory actions to be taken (e.g., direct the AI to replace the individual concerned or require the AI to enhance its system of control within a reasonable period of time).</p> <p>SPM CG-1 section 5.3 provides that the Board should have plans for orderly succession in respect of appointments to the Board and to senior management, so as to maintain an appropriate balance of skills and experience within the AI and on the Board. In this regard, in the course of ongoing supervision of AIs, the HKMA will review the AI's succession plan for senior management. The HKMA will also observe whether the AI has encountered any problem in senior management transition for the purpose of assessing the adequacy and effectiveness of the AI's succession plan. The HKMA will raise any potential management succession issues with the AI and request the AI to devise a plan for resolving them. In the annual CAMEL rating review, all relevant information on management succession will be reflected in consideration of the "Depth &amp; succession of senior management" which is one of the assessment factors of the "Management" component.</p> <p>The Board is responsible for ensuring that senior management is competent in implementing strategic decisions approved by the Board and supervising such performance on a continuing basis (SPM SR-1 "Strategic Risk Management" Paragraph 4.2.3). The Board should put in place effective systems of control to monitor senior management's performance against the performance objectives set by the Board for them on a continuing basis. The Board should question and critically review explanations and information provided by senior management.</p> <p>The HKMA performs the following steps to assess whether the Board oversees senior management's execution of Board strategies:</p> <ul style="list-style-type: none"> <li>• obtaining information/documents showing the strategies set by the Board, the AI's business plan for executing the strategies, and the arrangements for the senior management of the AI to report progress of implementation in the strategies to the Board.</li> <li>• obtaining in due course and reviewing the information/documents prepared by the senior management reporting on the progress/status of implementing the Board-approved strategies and the business plan to the Board.</li> <li>• obtaining and reviewing Board minutes to assess whether Board members have critically reviewed and discussed the report prepared by the senior management in the progress of implementation of the strategies and business plan.</li> <li>• at meetings with the AI's Board, discussing with, and seeking comments from, Board members on the performance of senior management against the</li> </ul>
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	<p>standards established.</p> <p>Usually, to measure how well senior management executes the strategies set by the Board, Board members would base their consideration on some pre-set performance indicators/benchmarks. According to SPM CG-5 “Guideline on a Sound Remuneration System”, performance indicators should include both financial and non-financial factors. Non-financial factors include adherence to risk management policies, compliance with legal, regulatory and ethical standards, results of internal audit reviews, adherence to corporate values, and customer satisfaction.</p> <p>When the HKMA review indicates that an AI’s Board does not actively and critically oversee senior management’s execution of strategies, the HKMA will communicate its concerns to Board members and request improvement. The HKMA will also reflect the findings in its annual CAMEL rating review and in its Pillar 2 Supervisory Review Process for locally incorporated AIs which may lead to a downgrade of the AI’s CAMEL rating and/or increase in minimum CAR/trigger CAR requirements.</p>
<b>EC7</b>	<p>The supervisor determines that the bank’s Board actively oversees the design and operation of the bank’s and banking group’s compensation system, and that it has appropriate incentives, which are aligned with prudent risk taking. The compensation system, and related performance standards, are consistent with long-term objectives and financial soundness of the bank and is rectified if there are deficiencies.</p>
<b>Description and findings re EC7</b>	<p>According to SPM CG-1 “Corporate Governance of Locally Incorporated Authorized Institutions” Paragraph 2.4.4, one of the key responsibilities of the Board is risk governance, including an overall remuneration policy that is in line with the risk tolerance/appetite and long-term interests of an AI and that promotes effective risk management. The Board’s responsibilities in overseeing the AI’s remuneration system and key elements of a sound remuneration system are set out in detail in SPM CG-5 “Guideline on a Sound Remuneration System.” They can be summarized as follows:</p> <ul style="list-style-type: none"> <li>• the Board should establish and maintain a written remuneration policy covering all employees that reflects the principles in SPM CG-5 and the policy should ensure that the AI’s overall approach to risk management is supported, and not undermined, by the remuneration arrangements for employees;</li> <li>• the remuneration policy should be designed to encourage employee behavior that supports the AI’s risk tolerance, risk management framework and long-term financial soundness, and should be in line with the objectives, business strategies and long-term goals of the AI;</li> <li>• the remuneration policy and its implementation should be subject to a regular (at least annual) review, independent of management, by the Board (or by a party commissioned by the Board) to ensure that the policy remains adequate and effective and that the operation of the remuneration system is consistent with the intended purposes and long-term interests of the AI; and</li> <li>• the structure of remuneration (including the balance between fixed and variable incentive-based remuneration, and the instruments for, and the timing of, paying the variable remuneration) and the pre-determined criteria for performance measurement should have regard to, among other things: <ul style="list-style-type: none"> <li>○ the need to promote behavior amongst employees that supports the AI’s</li> </ul> </li> </ul>



	<ul style="list-style-type: none"> <li>○ risk management framework and long-term financial soundness;</li> <li>○ the alignment of an employee's incentive awards with long-term value creation and the time horizons of risk; and</li> <li>○ the AI's performance over the longer term.</li> </ul> <p>After the issue of SPM CG-5, the HKMA issued a circular in April 2010 requesting AIs to conduct a self-assessment of their compliance with the principles stated in the SPM. The HKMA reviewed AIs' remuneration policies and the self-assessment results to assess the status of compliance and identify any compliance gaps, and required AIs to provide action plans to address any such gaps. The self-assessment results indicated that the major local AIs were broadly compliant with the guideline and the majority of foreign AI branches were close to being fully compliant.</p> <p>In 2011, a round of thematic examinations on the remuneration systems and practices of ten selected AIs (locally incorporated banks and branches of foreign banks with significant business operations in Hong Kong, which had introduced variable incentive compensation arrangements) was conducted to assess their compliance with SPM CG-5, including Board oversight on the design and operation of the compensation system. In general, the results indicated that the AIs' progress in implementing the guideline was satisfactory and their remuneration policies and practices broadly complied with the principles for a sound remuneration system. The remuneration systems and practices of some AIs, including Board oversight on the design and operation of the compensation system, were also reviewed as part of risk-based on-site examinations of selected AIs during 2012.</p> <p>As stated in SPM CG-5 Paragraph 2.1.3, AIs are expected to conduct regular internal monitoring to ensure that their processes for ensuring compliance with their remuneration policy are being consistently followed. In addition, the remuneration policy and its implementation should be subject to a regular (at least annual) review, independent of management, by the Board (or by a party commissioned by the Board) to ensure that the policy remains adequate and effective and that the operation of the remuneration system is consistent with the intended purposes and long-term interests of the AI. The HKMA collects and reviews these monitoring and independent review reports in its ongoing supervision to ensure AIs continue maintaining effective compensation systems.</p> <p>AIs' remuneration systems and practices are taken into account in the annual CAMEL rating review and the Pillar 2 SRP for locally incorporated AIs. In the CAMEL rating review, the AI's "Compensation &amp; Remuneration Policies" is one of the assessment factors of the "Management" component. In the Pillar 2 SRP, "Soundness of remuneration policies and practices" is embedded in the assessment scorecard for "Corporate Governance."</p> <p>Deficiencies in AIs' remuneration systems and practices, identified in the HKMA's ongoing supervisory process, are raised with the AIs concerned and remedial actions are required.</p> <p>Going forward, the HKMA will review AIs' systems of remuneration and compensation</p>
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	regularly in its off-site surveillance and on-site examination to ensure the systems continue to comply with the requirements in the SPM and are enhanced in the light of implementation experience and the development of best practices, both locally and overseas. In February 2013 the Banking Supervision Department case teams were instructed to schedule on-site and off-site review of AIs' systems of remuneration.
<b>EC8</b>	The supervisor determines that the bank's Board and senior management know and understand the bank's and banking group's operational structure and its risks, including those arising from the use of structures that impede transparency (e.g., special-purpose or related structures). The supervisor determines that risks are effectively managed and mitigated, where appropriate.
<b>Description and findings re EC8</b>	<p>The supervisory requirements in respect of the Board and senior management oversight of organizational structure and the associated risks are set out in SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" section 2.7, which can be summarized as follows:</p> <p><i>Understanding operational structure and its risks</i></p> <ul style="list-style-type: none"> <li>• the Board and senior management of an AI should understand and guide the AI's structure and organization and ensure that organizational complexity does not prevent effective control of the AI's activity in its entirety. For this purpose, the Board should understand: <ul style="list-style-type: none"> <li>○ the purpose and aim of the different parts of, and entities within, the AI's organizational structure and the formal and informal links and relationships between them; and</li> <li>○ the legal and operational risks and constraints of the various types of intra-group exposure and transaction; and</li> <li>○ how the above affect the group's funding, capital and risk profile under normal and adverse circumstances;</li> </ul> </li> <li>• the Board should ensure that it keeps itself informed about the risks caused by the group structure;</li> <li>• the senior management should understand the AI's structure and recognize the risks that the complexity of the structure itself may pose (e.g., lack of management transparency, operational risks introduced by interconnected and complex funding structures, intra-group exposure, trapped collateral and counterparty risk).</li> </ul> <p>In order to manage and mitigate risks associated with an AI's operational structure:</p> <ul style="list-style-type: none"> <li>• the Board should set clear strategies and approve policies for the establishment of new units, branches, subsidiaries or other legal entities within the AI's organizational structure;</li> <li>• the senior management should put in place a centralized process for approving and controlling the creation of new legal entities based on established criteria and avoid setting up unnecessarily complicated structures;</li> <li>• the senior management should recognize the risks that the complexity of the structure itself may pose and evaluate how these risks affect the group's ability to manage its risk profile; and</li> <li>• regular assessments of the risks posed by the group's structure are recommended.</li> </ul>

The HKMA performs the following steps, in the course of the annual off-site review or risk-based on-site examination, as appropriate, in determining whether an AI's Board and senior management understand (and manage) the AI's and the banking group's operational structure and related risks:

- collecting and reviewing an AI's business plan to understand, among other things, if there is any plan re change of corporate structure in the coming future.
- collecting and reviewing the information passed to the Board and senior management to ascertain whether the Board and senior management are informed of the operational structure regularly.
- collecting and reviewing the relevant meeting minutes to ascertain that the Board and senior management have rigorously discussed the operational structure and the risk implications in maintaining the structure given the prevailing market conditions, legal and regulatory environments, etc., and endorsed the operational structure after the discussion.
- when the HKMA has any concerns on the appropriateness of the operational structure of the AI (e.g., using structures that may impede transparency), it will further collect and review relevant documents from the AI, including risk assessment reports, records of approval of new establishment, meeting minutes of the Board / Board-level committees and management-level committees, to assess whether the risk factors associated with the operational structure have been thoroughly considered by the Board and senior management, and whether they have proposed/endorsed measures to manage and mitigate the risks.

In addition to the above steps taken to evaluate how the Board and senior management of an AI manage operational structure, the HKMA will keep track of the development of the operational structure of an AI in its day-to-day supervision of the AI. The purpose of such monitoring is to ensure that any change of the AI's operational structure, and the risk implications, can be identified at an early stage. The detailed practices taken by the HKMA in this regard are described as follows:

In the course of ongoing supervision of AIs, the HKMA regularly (at least annually) collects group charts and reviews the operational structure of AIs or banking groups, including the establishment of new branches, subsidiaries, special purpose vehicles or other changes in organization structure. For some listed AIs or banking groups, the HKMA also reviews the relevant sections in their annual / interim reports (e.g., list of subsidiaries, connected transactions, etc.) to get an update on the operational structure of the AIs/banking groups and assess the relevant risks.

When reviewing the operating structure of an AI, the HKMA assesses whether the AI has used structures that would impede transparency or will undermine the HKMA's supervision over the activities of the AI or banking group. The HKMA also assesses the implication of newly established subsidiaries or major changes of operating structure on the AI's resources, risk profile, risk management and internal control environment taking into account the nature, scale and complexity of the AI's operation.

	<p>When an AI establishes a new structure, such as a special purpose vehicle (SPV) to engage in certain businesses, the HKMA would discuss the justification for doing so with the AI's senior management. Subject to the complexity of the new structure and the nature of the new businesses to be undertaken by the new structure, meetings are held with the AI to gain an understanding of the associated risks and how these risks are managed and overseen by the AI's management.</p> <p>The appropriateness of an AI's organization structure and the adequacy of its control environment is fed into the HKMA's annual CAMEL rating review (i.e. assessment of the "Management" component) and into the Pillar 2 Supervisory Review Process for locally incorporated AIs (i.e. assessment of "Internal Control System and Environment"). So far, the HKMA notes that most locally incorporated banks in Hong Kong maintain relatively simple corporate operational structures. If the assessment reveals that the Board and the senior management are seeking to adopt more complex structures that obscure risk or seek to remove activities from the ambit of supervision, the HKMA will downgrade the CAMEL rating and/or increase the minimum CAR requirements to reflect the increased risk. The AI may also be asked to make adequate loss provision to cover the businesses/activities related to the complex structure within a reasonable period of time or even to wind down the business/operation so as to reduce its interconnectedness with the AI.</p> <p>The HKMA is actively participating in the work being carried out in CMGs for nine G-SIBs. Through the CMGs, the HKMA is able to better understand the group operating structures of these G-SIBs to ensure that the RRP set for these G-SIBs will be effective. In due course, the HKMA will commence its assessment on the RRP for domestic systemically important banks (and possibly other local AIs). The group structure of these AIs will be thoroughly reviewed further during this process.</p>
<b>EC9</b>	<p>The supervisor has the power to require changes in the composition of the bank's Board if it believes that any individuals are not fulfilling their duties related to the satisfaction of these criteria.</p>
<b>Description and findings re EC9</b>	<p>BO Schedule 7 Paragraph 4 provides that the MA must be satisfied that the directors of a locally incorporated AI are fit and proper to occupy their positions. The MA will assess whether a prospective director is fit and proper based on the assessment criteria set out in the Authorization Guideline (Paragraphs 13 – 22) and in the GTA Chapter 4 (Paragraphs 4.12 – 4.21). Such criteria also apply to approved directors on an ongoing basis.</p> <p>Under BO section 71(4), the MA has the power to withdraw his consent given under BO section 71(1) to a director of an AI incorporated in Hong Kong if he has ceased to be satisfied that the director is a fit and proper person to be such director (e.g., by virtue of the director being incompetent or not fulfilling his duties related to the minimum standards set out in SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions"). In this connection, the HKMA may, where necessary, conduct face-to-face meetings with serving directors to determine whether they remain fit and proper to carry out the duties of a director.</p>

	<p>In practice, if the HKMA considers that an AI's Board or individual Board members are failing to fulfill their duties, the HKMA will conduct a thorough assessment to determine whether a particular director continues, or a group of directors continue, to remain fit and proper to carry on the duties of directorship of the AI.</p> <p>In the assessment process, the HKMA will, among other things, interview individual Board members and senior management of the AI to collect information for evaluation. Where necessary, the HKMA may request the AI to commission an external auditor's review pursuant to BO section 59(2) to evaluate the matter.</p> <p>If the assessment concludes that a particular director is, or a group of directors are, no longer fit and proper to hold their position(s), the HKMA would communicate the assessment result to the chairman of the Board for his appropriate action. The HKMA would also discuss other action with the AI's Board to strengthen the composition of the Board and rectify any associated corporate governance weaknesses identified.</p> <p>If the assessment concludes that all directors remain fit and proper to hold their positions, the HKMA would still consider the need to require the AI's Board to strengthen its composition and take measures to improve corporate and risk governance.</p> <p>In most of the cases encountered by the HKMA to date where directors have not been considered as fit and proper, they have voluntarily resigned their directorships.</p>
<b>Additional criteria</b>	
<b>AC1</b>	Laws, regulations or the supervisor require banks to notify the supervisor as soon as they become aware of any material and bona fide information that may negatively affect the fitness and propriety of a bank's Board member or a member of the senior management.
<b>Description and findings re AC1</b>	<p>Under SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" Paragraph 10.3.2, an AI should notify the HKMA as soon as it becomes aware of any material information that may negatively affect the fitness and propriety of a Board member or a member of the senior management.</p> <p>It is also stated in SPM CG-2 "Systems of Control for the Appointment of Managers" Paragraph 3.1.3 that if an AI becomes aware of any information that may call into question the fitness and propriety of an existing manager, it should conduct a thorough assessment or investigation to determine whether the person is fit and proper. SPM CG-2 Paragraph 6.1.5 specifies that AIs should inform the MA, as soon as practicable, of cases where managers are removed from their positions because of fraud, dishonesty or malpractice.</p>
<b>Assessment of Principle 14</b>	Compliant.
<b>Comments</b>	The HKMA places a great deal of emphasis on the importance of sound and effective corporate governance at AIs, irrespective of whether they are a local institution or the branch or subsidiary of a foreign bank. Their oversight of the quality of corporate

	governance serves as the basis for their on- and off-site work and they endeavor to develop a sound understanding of the effectiveness of Boards, Board Committees and senior management. This process includes periodic meetings with Board members, especially the independent directors and an interview process on a selective basis for candidates for Board positions.
<b>Principle 15</b>	Risk management process. The supervisor determines that banks <sup>38</sup> have a comprehensive risk management process (including effective Board and senior management oversight) to identify, measure, evaluate, monitor, report and control or mitigate <sup>39</sup> all material risks on a timely basis and to assess the adequacy of their capital and liquidity in relation to their risk profile and market and macroeconomic conditions. This extends to development and review of contingency arrangements (including robust and credible recovery plans where warranted) that take into account the specific circumstances of the bank. The risk management process is commensurate with the risk profile and systemic importance of the bank. <sup>40</sup>
<b>Essential criteria</b>	
<b>EC1</b>	<p>The supervisor determines that banks have appropriate risk management strategies that have been approved by the banks' Boards and that the Boards set a suitable risk appetite to define the level of risk the banks are willing to assume or tolerate. The supervisor also determines that the Board ensures that:</p> <ul style="list-style-type: none"> <li>(a) a sound risk management culture is established throughout the bank;</li> <li>(b) policies and processes are developed for risk-taking, that are consistent with the risk management strategy and the established risk appetite;</li> <li>(c) uncertainties attached to risk measurement are recognized;</li> <li>(d) appropriate limits are established that are consistent with the bank's risk appetite, risk profile and capital strength, and that are understood by, and regularly communicated to, relevant staff; and</li> <li>(e) senior management takes the steps necessary to monitor and control all material risks consistent with the approved strategies and risk appetite.</li> </ul>
<b>Description and findings re EC1</b>	<p>SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" and SPM IC-1 "General Risk Management Controls", provide that the Board of an AI should do the following:</p> <p><i>Risk management strategy and risk appetite</i></p> <ul style="list-style-type: none"> <li>• approve the overall risk management strategy including a clearly articulated risk tolerance / appetite, for the AI which should be commensurate with the</li> </ul>

<sup>38</sup> For the purposes of assessing risk management by banks in the context of Principles 15 to 25, a bank's risk management framework should take an integrated "bank-wide" perspective of the bank's risk exposure, encompassing the bank's individual business lines and business units. Where a bank is a member of a group of companies, the risk management framework should in addition cover the risk exposure across and within the "banking group" (see footnote 19 under Principle 1) and should also take account of risks posed to the bank or members of the banking group through other entities in the wider group.

<sup>39</sup> To some extent the precise requirements may vary from risk type to risk type (Principles 15 to 25) as reflected by the underlying reference documents.

<sup>40</sup> It should be noted that while, in this and other Principles, the supervisor is required to determine that banks' risk management policies and processes are being adhered to, the responsibility for ensuring adherence remains with a bank's Board and senior management.

	<p>AI's operations and strategic goals, risk management and compliance capabilities;</p> <ul style="list-style-type: none"> <li>• approve key risk management policies and oversee management in developing policies and practices to manage risk in accordance with the board's strategy and the AI's risk tolerance / appetite;</li> </ul> <p><i>Risk management culture</i></p> <ul style="list-style-type: none"> <li>• create a strong corporate and risk management culture and ensure the AI's risk appetite is well enshrined within the culture;</li> </ul> <p><i>Policies and processes for risk-taking</i></p> <ul style="list-style-type: none"> <li>• ensure that an effective risk management framework is in place to facilitate an integrated approach to managing the AI's firm-wide risks. The framework should enable the identification and management of all major risks across business activities;</li> </ul> <p><i>Recognition of uncertainty</i></p> <ul style="list-style-type: none"> <li>• recognize the biases and assumptions embedded in, and the constraints of, the methods or models chosen for risk measurement to better assess the results. To enable proactive risk management, the risk management information system should be capable of incorporating multiple perspectives of risk exposure to account for uncertainties in risk measurement and the occurrence of emerging risk;</li> <li>• ensure methodologies for measuring valuation uncertainty are developed and appropriate procedures for considering valuation adjustments are established and maintained for the purpose of risk management, and regulatory and financial reporting; and</li> </ul> <p><i>Risk limits</i></p> <ul style="list-style-type: none"> <li>• ensure that risk limits (which should be in line with the AI's risk appetite and suitable for the size and complexity of the AI's business activities as well as the sophistication of its products and services) are subject to regular review. The limits should be communicated to, and understood by, relevant staff members.</li> </ul> <p><i>Risk monitoring and control</i></p> <ul style="list-style-type: none"> <li>• determine that the risk management framework is properly implemented and maintained by senior management and meet regularly with senior management and internal control functions (including those responsible for risk management) to review policies and controls in order to identify areas that need improvement and address significant risks and issues.</li> </ul> <p>Under SPM IC-2 "Internal Audit Function" Paragraphs. 1.2.1 and 2.4.2, an AI is expected to maintain an internal audit function responsible for assessing the effectiveness of the systems and processes for risk management and control throughout the organization (thereby assisting the Board and senior management in ensuring compliance with prescribed risk management policies and processes).</p> <p>Evaluation and determination of whether an AI has formulated an appropriate risk</p>
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	<p>management structure is at the core of the HKMA's risk-based supervision. The HKMA assesses an AI's risk management quality in its ongoing supervisory work through a variety of means including regular contact with the AI's senior management and review of the AI's risk management policies and procedures, management information system (MIS) reports, meeting minutes of the Board and specialized committees, and internal audit reports.</p> <p>The reviews are performed by way of off-site review of materials provided by the AI, on-site inspection of the AI's policies, reports and other written records, face-to-face interviews with senior management and information sharing with the AI's external auditors where appropriate. In order to assess the quality of risk management, the relevant BSD case team collects and reviews information on items such as the following, taking into account the size and complexity of business and the systemic importance of the AI:</p> <ul style="list-style-type: none"> <li>• the extent to which the AI's risk management strategies and risk appetite are adequately documented. The risk appetite statement should be formulated by the Board directly or reviewed and duly approved by the Board.</li> <li>• the extent to which there is an adequate mechanism, such as through the use of performance indicators, to measure how well the risk management strategies and risk appetite are being observed by the AI.</li> <li>• information packs submitted regularly to the Board/Board-level specialized committees demonstrating the extent to which senior management updates Board members in respect of the performance indicators (for measuring how well the risk management strategies and risk appetite are being implemented) on a timely basis.</li> <li>• minutes of the Board/Board-level specialized committees demonstrating thorough discussion among the Board members of the performance indicators and adjustments to risk management strategies and risk appetite whenever deemed necessary after considering the AI's prevailing risk profile, latest macroeconomic conditions and up-to-date regulatory requirements.</li> <li>• Board minutes demonstrating cultivation of an appropriate risk management culture throughout the AI including through enforcing effective risk management systems and policies, and establishing and supporting a robust internal control environment (such as having a risk management function, compliance function and internal audit function within the AI independent of business / risk-taking units, and assigning adequate status to, and delegating adequate authority to, the personnel in charge of these functions to enable them effectively to perform their risk management and internal control duties).</li> <li>• the extent to which the AI has put in place a comprehensive set of risk management policies and procedures, covering the key risks facing the AI, including but not limited to credit risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk, reputation risk and strategic risk. These policies and procedures should properly reflect the risk management strategies and risk appetite set by the Board and the core elements of these policies and procedures should be endorsed by the Board.</li> <li>• the extent to which there are systems in place to monitor staff compliance with the risk management policies and procedures, and to escalate any exceptions</li> </ul>
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	<p>to senior management and the Board, as appropriate, on a timely basis.</p> <ul style="list-style-type: none"> <li>• among other factors, evidence that the chief executive and other senior management of the AI give due attention to the risks arising from the business conducted by the AI and proactively discuss, monitor and take steps to control all material risks. The extent to which the chief executive has made extensive use of any specialized committees of the AI as forums for the management team to manage these risks. The extent to which minutes of these committees have properly documented the related discussion and deliberations.</li> </ul> <p>The BSD case team also assesses whether the AI has a clear organization structure to segregate risk taking units from risk management units. In practice, local banks and major foreign banks branches have established and maintained a dedicated risk management unit that is overseen by a Chief Risk Officer (CRO). For those small AIs with a simple organization structure, the HKMA accepts that they appoint other senior management staff (instead of a dedicated CRO) to oversee the risk management functions provided that this arrangement will not compromise the independence and effectiveness of these AIs' risk management functions. (See EC 10 for further details about the HKMA's requirements on the roles played by CROs.)</p> <p>In the case of foreign AIs, the BSD relies on the home supervisors to confirm the adequacy of the oversight exercised by the Board. The BSD also meets the senior management and internal auditors from the foreign AIs' head office or regional headquarters when they come to Hong Kong to assist in gaining an understanding of how the Board and senior management at Head Office level view and manage risk.</p> <p>At a local level, the BSD will however remain attentive to the adequacy of local management oversight of the risk management controls for the Hong Kong operation. In this regard, notwithstanding the usual matrix reporting structure of foreign AIs, the HKMA has been promoting the requirement or supervisory expectation that local senior management (i.e. the chief executive of the Hong Kong Branch of a foreign bank) should have full responsibility for all matters with implications for the Hong Kong operation in order to ensure adequate accountability locally. Given this expectation, the local senior management of foreign AIs have been increasing their communication with other local business and control functions as well as with the Head Office, where necessary, for better oversight of the Hong Kong operations.</p> <p>The HKMA also requires AIs to conduct a self-assessment on specific aspects of their risk management controls and on follow-up actions taken, or to be taken, by them in closing identified gaps. For example, AIs were required to conduct a self-assessment exercise in March 2009 on their compliance with the Principles for Sound Liquidity Risk Management and Supervision issued by Basel in September 2008. The BSD has taken into account the result of the self-assessment as part of their Supervisory Review Process and CAMEL rating assessment of individual AIs.</p> <p>The adequacy and effectiveness of an AI's risk management process is one of the factors in the "risk management system" component under the Supervisory Review Process (see SPM CA-G-5 scorecard (B1) on Risk Management System, page 128). The BSD case team forms a view (i.e. weak, acceptable or strong) on the adequacy of the</p>
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	<p>AI's policies, procedures and limit structures (PPL) which will then feed into the score for the "risk management system" component (see SPM CA-G-5 overall scorecard, page 116). Together with other risk factors, the score will determine the Pillar 2 capital add-on requirement for the AI. An AI with a weak risk management process would attract a higher capital add-on under Pillar 2 which would translate into a higher minimum CAR requirement.</p> <p>The relative strength an AI's risk management process will also affect the individual "Management" rating and ultimately the composite CAMEL rating assigned to the AI, which in turn will affect the supervisory plan set by the HKMA for the AI.</p> <p>When an AI is assessed as having a less-than-satisfactory risk management system (for example, because of an inappropriate risk management strategy or risk appetite; a failure to promote a strong risk management culture; or inadequate risk management policies, procedures and limits), the HKMA would communicate its observations to the AI's senior management and require prompt action to rectify the position as soon as possible. If considered appropriate, it is the general practice of the HKMA to convey its views on the quality of the AI's risk management, and recommendations for improvement, to the AI's Board members through meetings</p> <p>The HKMA monitors the progress of rectification action taken by an AI in its ongoing off-site review. The review will focus on the timeliness of implementation (i.e. whether implementation is made in accordance with the timeline agreed with the HKMA) and the effectiveness of the rectification actions taken. In reviewing effectiveness, the BSD will request the AI to provide evidence demonstrating the remedial actions taken (e.g., the revised risk management policies and internal MIS reports, etc.) When most remedial actions have been completed, the BSD would conduct an on-site inspection to walk through the relevant risk management processes of the AI, with a view to ascertaining the adequacy of the remediation.</p>
<b>EC2</b>	<p>The supervisor requires banks to have comprehensive risk management policies and processes to identify, measure, evaluate, monitor, report and control or mitigate all material risks. The supervisor determines that these processes are adequate:</p> <ul style="list-style-type: none"> <li>(a) to provide a comprehensive "bank-wide" view of risk across all material risk types;</li> <li>(b) for the risk profile and systemic importance of the bank; and</li> <li>(c) to assess risks arising from the macroeconomic environment affecting the markets in which the bank operates and to incorporate such assessments into the bank's risk management process.</li> </ul>
<b>Description and findings re EC2</b>	<p>SPM IC-1 "General Risk Management Controls" Paragraph 1.1.3 provides that AIs should establish a sound and effective system to manage each of the eight inherent risks (viz. credit, market, interest rate, liquidity, operational, reputation, legal and strategic) to which they are exposed (see also SPM SA-1 "Risk-based Supervisory Approach" section 2). AIs are expected to have in place a comprehensive risk management system to identify, measure, monitor and control the various types of risks within all of their activities and, where appropriate, to hold capital against these risks.</p>

	<p>SPM SA-1 “Risk-based Supervisory Approach” sections 3 and 4 set out the HKMA’s views of a sound risk management system and the factors in assigning a rating to the overall risk management system.</p> <p>As specified in SPM IC-1 “General Risk Management Controls” Paragraph 3.1.1, AIs should have clearly defined policies and procedures that enable firm-wide risks to be managed in a proactive manner, with emphasis on achieving:</p> <ul style="list-style-type: none"> <li>• objective and consistent risk identification and measurement approaches;</li> <li>• comprehensive and rigorous risk assessment and reporting systems;</li> <li>• sound valuation and stress-testing practices; and</li> <li>• effective risk monitoring measures and controls.</li> </ul> <p>Moreover, the AI’s risk management policies and procedures as well as its risk management framework should:</p> <ul style="list-style-type: none"> <li>• be developed based on a comprehensive review of all business activities of the AI and cover all material risks;</li> <li>• be prepared on a firm-wide basis and, where applicable, on a group-wide basis;</li> <li>• facilitate an integrated approach to managing firm-wide risks, enabling identification and management of all major risks across business activities, whatever the nature of the exposure;</li> <li>• take into account a number of factors including those reflecting the risk profile and systemic importance of the AI; and</li> <li>• take into consideration anticipated external changes such as changes in market conditions and keep pace with the changing environment.</li> </ul> <p>Decisions determining the level of risk to be taken should explicitly address relevant macroeconomic trends and data to identify their potential impact on particular business activities of the AI. Such assessments should be formally integrated in material risk decisions.</p> <p>The HKMA requires every AI to have a set of Risk Policies, Procedures, and Limits (PPL) that are commensurate with its scale of business and risk profile. The BSD will review the documents describing an AI’s PPL through off-site review and during the course of on-site examinations.</p> <p>In reviewing the PPL, the BSD looks at whether the PPL, as a whole, are able to capture all the material risk types facing the AI. The BSD expects that, at a minimum, the PPL should cover the eight key risks facing a generic commercial bank.</p> <p>The BSD would regard an AI’s PPL as capable of identifying, measuring and evaluating material risks if:</p> <ul style="list-style-type: none"> <li>• the AI has a clear firm-wide definition for different types of risk and has put in place systems to aggregate risks on a firm-wide basis.</li> </ul>
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- for each business activity or major product or service, the AI identifies what risks are inherent in the activity / product / service and establish appropriate methods to measure each and every type of risk.
- for each type of risk inherent in the AI's businesses / operations, the AI has set up appropriate systems and procedures to measure the risk level on an ongoing basis. The AI sets up a limit structure to cap the risk level within the Board's approved risk appetite having regard to the AI's scale and complexity of operations.
- for each type of risks inherent in the AI's businesses / operations, the AI has a reporting mechanism to report the level and direction of risk to the senior management and the Board on a timely basis.
- the AI has procedures in place to identify excessive risk-taking behavior and escalate exceptions to the Board and senior management in a timely manner for rectification.
- the AI has a clear organization structure to segregate risk-taking units from risk management units, which should be overseen by a dedicated CRO (or, in case of some small AIs with simple organization structure, a senior management person with sufficient independence from risk-taking functions). (See also assessment under EC 10.)

In addition to the above, the BSD also looks for the following arrangements to assess whether the PPL of an AI is complete and adequate in reporting and controlling risk.

- Specialized committees (e.g., Risk Management Committee, Assets & Liabilities Committee) are established at Board-level and management level for discussion and resolution of issues concerning different types of risks, and consolidate a firm-wide risk profile of the AI across all material risk types.
- The conduct by an AI of stress tests that are adequate to assess its capability to withstand adverse market conditions in terms of liquidity, capital adequacy and earnings based on valid assumptions and reasonably stressful scenarios, reflecting macroeconomic situation. The results of the stress tests are taken into account in the setting of business and risk management strategies and appetites, and in the management of capital adequacy and funding & liquidity positions. When the stress test results indicate that the AI is taking risks that are beyond its risk tolerance level, the Board and the senior management adjusts the AI's balance sheet structure and/or business plan to reduce the risk level.

The BSD will, as appropriate, engage in face-to-face interviews with senior management to gather further information on PPL and will also seek to obtain information from the AI's external auditors and internal auditors as necessary.

The adequacy of an AI's PPL is one of the factors in the "Risk Management System" component under the Supervisory Review Process. The BSD case team forms a view (i.e. weak, acceptable or strong) on the adequacy of the AI's PPL which will then feed into the score for the "risk management system" component. Together with other risk factors, the score will determine the Pillar 2 capital add-on requirement for the AI. An AI with a weak PPL will likely attract a higher capital add-on under Pillar 2.

	<p>The relative adequacy of an AI's PPL will also affect the individual rating assigned for the "Asset" and "Management" components in the CAMEL Rating Assessment. These ratings would in turn affect the composite CAMEL rating assigned to the AI, which would ultimately affect the supervisory plan set by the BSD for the AI.</p> <p>When an AI's PPL is assessed as less-than-satisfactory or inadequate, the BSD would communicate its observations to the AI's senior management and require remedial action to rectify the position as soon as possible.</p>
<b>EC3</b>	<p>The supervisor determines that risk management strategies, policies, processes and limits are:</p> <ul style="list-style-type: none"> <li>(a) properly documented;</li> <li>(b) regularly reviewed and appropriately adjusted to reflect changing risk appetites, risk profiles and market and macroeconomic conditions; and</li> <li>(c) communicated within the bank.</li> </ul> <p>The supervisor determines that exceptions to established policies, processes and limits receive the prompt attention of, and authorization by, the appropriate level of management and the bank's Board where necessary.</p>
<b>Description and findings re EC3</b>	<p>SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" and SPM IC-1 "General Risk Management Controls" provide that an AI's risk management strategies, policies, procedures and limits should be:</p> <ul style="list-style-type: none"> <li>• properly documented;</li> <li>• properly and regularly reviewed and updated to ensure adequacy and appropriateness under changing business and market conditions; and</li> <li>• communicated to the business units and understood by the relevant staff members.</li> </ul> <p>Exceptions to limits and policies should be reported promptly to the senior management for necessary action (SPM IC-1 Paragraph 3.2.7 and 4.2.3). Where the authority for risk management is delegated formally to a specialized committee such as a Credit Committee or Risk Management Committee, appropriate reports should be submitted regularly to the Board by the committee to which such authority has been delegated.</p> <p>During an on-site examination, an AI's compliance with the requirements prescribed under this EC is verified.</p> <p>The on-site examiners form a view on whether the documented PPL accurately reflects the actual risk management practices being deployed by the AI, or whether the PPL can effectively facilitate proper management of risks. If there are gaps between practices and the PPL, the reasons why procedures differ from documented PPL would be investigated. In connection with this, the on-site examiners would also form a view on whether the PPL are reviewed by senior management and the Board regularly and whether the PPL are updated periodically where appropriate to reflect the changing</p>

	<p>internal and external conditions. Through interviews with the line officers and middle management, the examiners verify that bank staff are familiar with the PPL and observe the PPL in practice.</p> <p>On-site examiners pay particular attention to exception monitoring. Examiners obtain and review the list of MIS reports and exception reports during the on-site examination to ascertain that exceptions are handled in an appropriate manner.</p> <p>When the on-site examination is completed, the on-site examiners would communicate their findings in relation to PPL documentation, updating and exception monitoring, if any, to the AI's senior management and request implementation of remedial measures as necessary. The on-site examination findings would be taken into account when the HKMA conducts its Pillar 2 Supervisory Review Process and its CAMEL rating review of the AI.</p> <p>Going forward, the HKMA will continue to expend effort on reviewing AIs' procedures for identifying exceptions to PPL in its ongoing supervision of AIs. The HKMA also plans to request all local AIs to establish a framework to review and update their risk appetite in a more systematic manner, and to request their Boards to compare an AI's risk profile against the formally approved risk appetite more frequently (at least quarterly) taking into account their assessment of the medium term macroeconomic environment.</p>
<b>EC4</b>	<p>The supervisor determines that the bank's Board and senior management obtain sufficient information on, and understand, the nature and level of risk being taken by the bank and how this risk relates to adequate levels of capital and liquidity. The supervisor also determines that the Board and senior management regularly review and understand the implications and limitations (including the risk measurement uncertainties) of the risk management information that they receive.</p>
<b>Description and findings re EC4</b>	<p>During the course of an on-site examination, the BSD assesses whether the Board and senior management of an AI obtain sufficient information concerning the type and levels of risk being taken by the AI. In addition, the BSD assesses whether an AI's Board and senior management understand the risk of the AI through the annual meeting with the Board / Board-level committees of locally incorporated banks and the prudential meetings with the chief executives and other senior management executives of AIs. In these meetings, the BSD invites, as appropriate, directors and senior management to give an assessment on the nature and level of risk being taken by the AI and an opinion on the adequacy of capital and liquidity maintained by the AI. Based on the views and comments given by the directors and senior management in these occasions, the BSD forms a view as to whether the directors and senior management understand the risk profile of the AI and the implications/limitations of the risk management information that they receive.</p> <p>In the case of locally incorporated AIs, the quality of Board and senior management oversight is also assessed (with the on-site exam results taken into account) during the Supervisory Review Process and the CAMEL rating review. After completion of the Supervisory Review Process and CAMEL review, the BSD will discuss with the senior management of the assessed AI the results of the assessment, including any areas of</p>

	concern that may lead to an increase in its minimum CAR or adjustment to its composite CAMEL rating.
<b>EC5</b>	The supervisor determines that banks have an appropriate internal process for assessing their overall capital and liquidity adequacy in relation to their risk appetite and risk profile. The supervisor reviews and evaluates banks' internal capital and liquidity adequacy assessments and strategies.
<b>Description and findings re EC5</b>	<p>As stipulated in SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" Paragraph 2.3.2, an AI should ensure that there is adequate capital and sufficient liquidity to cover the risk exposures and liquidity needs of the institution. Locally incorporated AIs are also required to have adequate internal systems for assessing capital adequacy in relation to the risks they assume (SPM CG-1 Paragraph 2.4.1). SPM LM-2 "Sound Systems and Controls for Liquidity Risk Management" Paragraph 1.2.2 expects an AI to maintain a liquidity risk management framework that, among other things, enables the AI to maintain adequate liquidity resources to cover the nature and level of liquidity risk to which it is or may be exposed. Paragraph 1.3.1 also specifies that locally incorporated AIs should apply the liquidity risk management standards set out in SPM LM-2 both on a legal entity basis and on a group basis, while AIs which are foreign banks operating in Hong Kong through branches are normally expected to apply such standards to their Hong Kong operations.</p> <p>As of August 2013, all of the 19 locally incorporated retail banks in Hong Kong have put in place an internal capital adequacy assessment process and apply it in managing their capital adequacy positions. These 19 locally incorporated retail banks are considered most important to the Hong Kong banking system.</p> <p>The BSD conducts the following steps to review and evaluate the effectiveness of a local AI's internal capital adequacy assessments and strategies:</p> <ul style="list-style-type: none"> <li>• reviews the AI's capital management policy and capital adequacy assessment process, with a view to assessing whether the AI has systematically (i) set any target range of CARs taking into account the AI's risk appetite, risk profile, and business strategies and plan (near, medium and long term plan), financial targets and changes in macroeconomic environment, (ii) established contingency plans and timetables to replenish capital (e.g., seeking fresh capital injection, asset disposal, scale-down of asset size or pace of business expansion) when CAR falls below certain levels.</li> <li>• monitors the trend of the CAR and capital structure of the AI based on the quarterly CAR return submitted. One of the major objectives of this supervisory monitoring work is to evaluate whether the AI has an effective internal capital adequacy assessment and planning process for maintaining a stable and strong capital position in line with its business nature and risk profile.</li> <li>• conducts top-down stress tests on the AI's CAR to check whether or not the prevailing CAR level is adequate to withstand risks, thus reflecting inadequacy in the bank's own capital management process.</li> </ul> <p>The adequacy of an AI's internal CAAP is one of the factors taken into account in the Supervisory Review Process and in assessing the CAMEL Rating of the AI. As a result,</p>

	<p>noticeably more efforts have been paid by AIs to fine-tune their CAAP in the past few years. The HKMA notes that the CAAP of some large and more complex local banks (especially those local banks that are using internal models to measure credit risk and market risk) are now relatively advanced in computing and managing economic capital using sophisticated statistical models. The remaining local banks tend to use a scorecard approach whereby scores are assigned to weigh the potential loss when residual risks, not captured under the Pillar 1 capital framework, materialize and to determine the amount of Pillar 2 capital required by transforming the scores into capital charges based on some internally set formulas. The scorecard approach adopted by these local banks closely resembles the approach used by the HKMA in its Supervisory Review Process for determining a locally incorporated AI's minimum level of regulatory capital.</p> <p>The HKMA recognizes that the scorecard approach adopted by some local banks is not as sophisticated / accurate as the economic capital approach for determining the amount of capital that the firm needs to support its business. Therefore, BSD staff will continue to closely monitor and assess the adequacy of the local retail banks' capital position using both top-down and bottom-up supervisor-driven stress tests. AIs with capital levels which fall short of withstanding the risks simulated in the stress tests will be subject to follow-up by the BSD for remedial actions.</p> <p>Going forward, the BSD plans to put more focus on a bottom-up supervisor-driven stress testing program that can help local retail banks better identify any weaknesses in their capital adequacy assessment and plan ahead for additional capital resources. AIs would then be requested to include the bottom up stress test program into their CAAP as well.</p> <p>The BSD assesses whether an AI's internal system for assessing liquidity adequacy and strategies is effective and commensurate with its risk appetite and risk profile and able to meet its financial obligations at both normal and stressed times, having regards to the approach adopted by it for assessing:</p> <ul style="list-style-type: none"> <li>• level and trend of liquidity ratio</li> <li>• loan-to-deposit ratio</li> <li>• composition / diversification / stability of funding source</li> <li>• maturity mismatch position</li> <li>• adequacy of high quality liquid assets</li> <li>• stability of deposit base</li> <li>• reliance on purchased funds and large-sized deposits</li> <li>• ability to access capital, money market and other sources of cash in normal and emergency situations</li> <li>• cost of funding</li> <li>• strength of parental support on liquidity</li> <li>• potential obligation for providing liquidity support in respect of contingent obligations (e.g., exposures to SIVs / conduits, etc.)</li> <li>• whether the AI has set up a firm-wide liquidity risk and funding management statement</li> <li>• funding and liquidity management strategy to cater business / asset expansion</li> </ul>
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	<ul style="list-style-type: none"> <li>• adequacy of liquidity to withstand stress events as indicated by the AI's internal stress test results or other relevant sources.</li> </ul> <p>The BSD reviews the above attributes to form a view on the adequacy of the AI's management of its liquidity position, taking into account the AI's size, complexity of business and systemic importance to the banking sector. The review is performed by way of off-site review of AI-provided information, on-site inspection of the whole risk management process, face-to-face interviews with senior management and information sharing with the AI's internal auditors where appropriate.</p> <p>Adopting a forward-looking approach, in the light of the possible termination of the Quantitative Easing policy in the United States which might in turn trigger a very significant outflow of funds from Hong Kong, the HKMA has made use since Q2 2013 of a top-down approach to identify AIs that might have gaps in their liquidity positions based upon the scenario of such financial market disruption taking place.</p> <p>The exercise stress-tested the ability of local AIs and major foreign bank branches in Hong Kong to maintain sufficient funds to meet their financial obligations on the assumption that there was a substantive outflow of funds from Hong Kong. The exercise has identified a few AIs which would have inadequate liquid funds to meet their obligations if the stress scenario were to occur. The HKMA has followed up on the test result by carrying out more in-depth reviews on the latest liquidity risk profile and management procedures of the concerned AIs, conveying the HKMA's concern to the AIs' senior management and requiring them to look into matter and take remedial measures.</p> <p>The BSD will factor its liquidity adequacy assessment of an AI into the Pillar 2 Supervisory Review Process Scorecard A3 "Liquidity Risk" and into relevant items in the scorecards B1, B2, B3, B4 and D1, and assign scores to indicate the HKMA's overall view on the AI's liquidity risk management. The AI's liquidity risk profile will affect the individual rating assigned for the "Liquidity" component in the CAMEL Rating Assessment. This rating will in turn affect the composite CAMEL rating assigned to the AI, which would ultimately affect the supervisory plan set by BSD for the AI.</p> <p>When an AI's liquidity risk management is assessed as less-than-satisfactory or inadequate, the HKMA would communicate its observations to the AI's senior management and require action to rectify the position as soon as possible.</p>
<p><b>EC6</b></p>	<p>Where banks use models to measure components of risk, the supervisor determines that:</p> <ul style="list-style-type: none"> <li>(a) banks comply with supervisory standards on their use;</li> <li>(b) the banks' Boards and senior management understand the limitations and uncertainties relating to the output of the models and the risk inherent in their use; and</li> <li>(c) banks perform regular and independent validation and testing of the models.</li> </ul> <p>The supervisor assesses whether the model outputs appear reasonable as a reflection</p>

	of the risks assumed.
<b>Description and findings re EC6</b>	<p>The HKMA requires AIs using models for risk assessment to have adequate policies, controls and procedures in place to validate, on a regular basis, the methodology and data and the robustness of the systems and processes involved in the modeling process. The validation should include regular back-testing and updates to reflect changing market conditions. AIs should ensure that validation is performed by individuals independent of the business functions concerned and the parties who have been involved in developing the models and systems.</p> <p>The HKMA also requires that the Board (or its designated committees) and senior management should recognize the limitations and assumptions embedded in, and the constraints of, the models chosen in order to better assess the results generated from those models, and should avoid over reliance on any specific risk model. In addition, they are expected to set up effective controls to ensure the integrity of the AI's overall risk management process and to monitor the AI's compliance with all applicable laws, regulations, supervisory standards, best practices and internal policies and guidelines.</p> <p>Through on-site examinations and off-site reviews, the HKMA monitors and evaluates AIs' compliance with the qualifying criteria for the approaches adopted by them for capital calculation purposes that involve IMM for calculating market risk, IRB approach for calculating credit risk, and IMM (CCR) approach for calculating counterparty credit risk. The results are fed back into the Supervisory Review Process under Pillar 2 of the capital framework. Under SPM CA-G-5 Paragraph 3.2.14, breach of qualifying criteria or existence of certain modeling deficiencies can be a risk-increasing factor that would lead the MA to consider imposing additional capital requirements on the AI.</p> <p>Where an AI uses models to measure risks, the BSD would, for each model adopted by the AI, assess:</p> <ul style="list-style-type: none"> <li>• whether the AI's senior management and Board understand the assumptions and parameters used in the models; the limitations and uncertainties relating to the output of the models; and the risk inherent in their use;</li> <li>• whether there is proper documentation of the assumptions and parameters used, and on the limitations and uncertainties;</li> <li>• whether the models are subject to independent validation and testing on a regular basis; and</li> <li>• whether the Board and senior management have signed off the model documents and validation reports and review MIS reports on a regular basis, evidencing that they understand the limitations and uncertainties relating to the output of the models and the risk inherent in their use.</li> </ul> <p>The BSD conducts the above-mentioned assessment of an AI on a regular or need basis, by way of off-site review and on-site inspections of relevant documents including, among others, model development and validation documents, the information package and MIS reports submitted to the Board and senior management and the minutes of the relevant committee meetings of the Board and senior management. Any deficiencies identified in this review process are communicated to the AI's senior management. The AI is required to implement actions to address the</p>

	<p>BSD's concerns within a reasonable period of time.</p> <p>AIs that plan to use internal models to calculate their regulatory capital charges are required to seek the prior approval of the MA, demonstrating to his satisfaction their compliance with the minimum requirements and other applicable provisions specified in the Banking (Capital) Rules. They are also required to conduct in-depth validation of these models on an annual basis to ensure their ongoing suitability for the AI's portfolios and to ensure that these models are performing as intended. The validation is required to be conducted by a party independent of the model developers, and the AI is required to establish a framework governing the process and interpretation of the results of the validation (including performance thresholds and follow-up actions if necessary). Such framework and the quality of the AI's independent validation form part of the BSD's ongoing review of AIs' internal models.</p> <p>An AI is also required to go through the model validation process whenever there are changes to the approved models in order to ensure the changes are justified, appropriate and tested. Where the changes are significant, review by and prior consent from the BSD would be required before they are implemented.</p> <p>As far as AIs' use of models for calculating capital charges is concerned, the BSD collects from the relevant AIs their model output for review from time to time. The review aims at verifying whether the output from the models is reasonable as a reflection of the risks assumed, and to assist the BSD to make relevant policy decisions in overseeing AIs' risk profile.</p> <p>An internal report "Analysis of IRB data" is compiled quarterly to highlight the trends of the IRB parameters (such as PD, LGD and EAD) and IRB asset classes both on an industry level and individual AI level. Outliers will also be identified. Based on the findings in this report, the BSD will follow up with an AI if it is an outlier or if abnormal movements in IRB data are observed.</p> <p>The BSD has also incorporated a procyclical factor for IRB risk weights into the top-down stress tests that are conducted regularly. This factor is designed to capture the cyclical sensitivity of IRB banks by taking into account bank-specific characteristics. Therefore, higher capital is required to adequately cover unexpected losses during downswings.</p> <p>Where appropriate (i.e. where the HKMA does not consider that the model output is reasonable as a reflection of prevailing risk levels), adjustment will be made to the risk weights generated by the internal models. For example, the HKMA has required AIs using the IRB approach to adopt a 15 percent risk-weight floor for all residential mortgage loans granted by these AIs after 22 February 2013 (see HKMA letter dated 22 February 2013).</p> <p>The BSD conducted an IRB Benchmarking exercise in 2010. The results were shared with the participating banks, highlighting those risk parameters which might have been underestimated when compared with peers.</p>
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<b>EC7</b>	The supervisor determines that banks have information systems that are adequate (both under normal circumstances and in periods of stress) for measuring, assessing and reporting on the size, composition and quality of exposures on a bank-wide basis across all risk types, products and counterparties. The supervisor also determines that these reports reflect the bank's risk profile and capital and liquidity needs, and are provided on a timely basis to the bank's Board and senior management in a form suitable for their use.
<b>Description and findings re EC7</b>	<p>As mentioned in EC 4, the HKMA requires AIs to establish an effective management information system that produces timely, accurate and reliable reports to their Board and senior management in a format fit for their respective use. The system should be able to:</p> <ul style="list-style-type: none"> <li>• effectively measure and report on the risks of major business activities within the organization even in times of stress;</li> <li>• aggregate data on a product, functional, geographical and group basis and, to the extent necessary, all sources of relevant risks by business line, portfolio and entity;</li> <li>• support customized identification and aggregation of risk concentrations within the AI;</li> <li>• facilitate the allocation of capital charges to business activities according to the level of risk-taking; and</li> <li>• encompass all significant sources of liquidity risk, including contingent risks and the related triggers and those arising from new activities.</li> </ul> <p>The Board is expected to be responsible for ensuring that the information systems and infrastructure are sufficiently resourced and supportive of the AI's risk management and reporting needs such that adequate oversight of firm-wide risk can be achieved.</p> <p>As part of the assessment of the effectiveness of an AI's risk management process, the BSD reviews the information systems of the AI to ensure that the systems are conducive to the effectiveness of the AI's risk management process. The review is conducted by means of: off-site review of different MIS reports used by the AI's risk management units in managing different types of risk and by the AI's Board and senior management in overseeing all material risks; on-site inspection on how the AI's staff make use of different MIS reports; interviews with the AI's staff, senior management and Board members on their understanding and familiarity with different MIS reports; and discussions with internal/external auditors on the comprehensiveness and accuracy of different MIS reports.</p> <p>The BSD forms a view on the adequacy of an AI's information systems, taking into account the size and complexity of the business of the AI and its systemic importance to the banking sector. The BSD will incorporate such view into the Pillar 2 Supervisory Review Process and CAMEL Rating assessment of the AI.</p>
<b>EC8</b>	The supervisor determines that banks have adequate policies and processes to ensure

	<p>that the banks' Boards and senior management understand the risks inherent in new products,<sup>41</sup> material modifications to existing products, and major management initiatives (such as changes in systems, processes, business model and major acquisitions). The supervisor determines that the Boards and senior management are able to monitor and manage these risks on an ongoing basis. The supervisor also determines that the bank's policies and processes require the undertaking of any major activities of this nature to be approved by their Board or a specific committee of the Board.</p>
<p><b>Description and findings re EC8</b></p>	<p>The Board and senior management of an AI are expected to comprehend the potential risks posed to the AI by each approved strategy, particularly in respect of those involving expansion through strategic alliances, mergers and acquisitions, or entry into new markets or business activities (SPM SR-1 Paragraph 4.2.2). The strategic risk management function of an AI should support the Board and senior management in managing an AI's strategic risk and facilitating change processes that contribute to the AI's organizational development and continuous improvement, in particular in identifying, assessing and reporting potential risks posed to the AI by its strategies (e.g., expansion into new markets, products or services) (SPM SR-1 Paragraph 4.4.1 &amp; 4.4.2).</p> <p>SPM IC-1 "General Risk Management Controls" Paragraph 2.3.3 specifies that the Board of an AI should be responsible for identifying, understanding and assessing the risks inherent in the AI's business activities (which would generally include major management initiatives such as changes in business model or systems and processes) or those in new products to be launched.</p> <p>SPM OR-1 "ORM" Paragraph 7.4.7 requires an AI to have policies in place which set out the standards and describe the roles and responsibilities for the AI's new product approval process. In addition, as set out in SPM IC-1 section 3.3, the "new product approval policy" of an AI should be internally approved and well documented, and address not only the development and approval of entirely new products and services but also significant changes in the features of existing products and services.</p> <p>SPM CA-S-10 "Financial Instrument Fair Value Practices" Paragraph 3.3.2 requires an AI to have documented procedures for new transaction types, products and markets and the related controls and risk management. The relevant approval processes should include all internal stakeholders relevant to risk management, risk control and financial reporting. The assignment and verification of valuations of financial instruments should be supported by a transparent, well-documented inventory of acceptable valuation methodologies that are specific and relevant to products and businesses.</p> <p>New products or services that could have a significant impact on the AI's risk profile should be brought to the attention of the Board or its designated committee (SPM IC-1 Paragraph 3.3.5). Moreover, the AI should perform a post-implementation evaluation of new products or services launched (SPM IC-1 Paragraph 3.3.6).</p>

<sup>41</sup> New products include those developed by the bank or by a third party and purchased or distributed by the bank.

	<p>SPM IC-1 Paragraph 3.3.7 specifies that the risk management function of an AI should participate in the process of approving new products or services (or significant changes to existing products or services). It should have a clear overview of the roll-out of new products or services (or significant changes to existing products or services) across different business activities. Where appropriate, it should have the power to require that significant changes to existing products or services go through the formal approval process applicable to new products or services.</p> <p>SPM LM-2 “Sound Systems and Controls for Liquidity Risk Management” Paragraph 2.3.5 requires that senior management should appropriately incorporate liquidity costs, benefits and risks in the internal pricing, performance measurement and new product approval process for all significant activities and Paragraph 3.5.2 requires the MIS to encompass all significant sources of liquidity risk, including contingent risks and the related triggers and those arising from new activities, and have the ability to calculate risk measures to monitor liquidity positions.</p> <p>The BSD reviews an AI’s new product development and approval process (NPP) regularly to ascertain whether new products, services or business initiatives introduced by an AI to the market have undergone proper assessment and due diligence so that the inherent risks are identified, measured, monitored, controlled and mitigated, and the new products, services or business initiatives have been approved internally at proper levels.</p> <p>Such reviews are undertaken during on-site examinations. The BSD on-site examiners collect and review policies and procedures relating to NPP. In most cases, the examiners carry out walk-through tests (i.e. to review all relevant documentation in respect of the development and approval of a particular product/service/business initiative) to ascertain that the NPP is duly adhered to.</p> <p>The BSD on-site examiners focus on the following aspects in the review:</p> <ul style="list-style-type: none"> <li>• whether there is a clear definition on products / services / business initiatives that should be subject to the new product development and approval process.</li> <li>• ascertaining that no new products / services / business initiatives launched during the period under inspection were mistakenly treated as existing products and bypass the new product development and approval process.</li> <li>• whether there is a process requiring product managers to identify all material risks inherent in new products and propose ways to mitigate the risks.</li> <li>• whether there is a process requiring risk management units to review, comment upon and endorse the risk assessment performed by product managers. Risk management units are expected to sign off on the risk assessment made by the product managers at the end of the due diligence process.</li> <li>• whether there is a process requiring the compliance function to review, comment upon and endorse the risk assessment performed by the product managers to ensure that the new products are compliant with regulatory and supervisory requirements. The Head of Compliance, or his delegate, is expected to sign off on the risk assessment made by the product managers at</li> </ul>
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	<p>the end of his/her due diligence process.</p> <ul style="list-style-type: none"> <li>• whether the NPP has defined clearly that, for material business initiatives, the risk assessment and due diligence performed by the product managers and risk management units should be further escalated to senior management or the Board/Board-level specialized committees, as appropriate, for deliberation and approval.</li> <li>• whether the new product / service / business initiative is launched to the market only after completion of the whole NPP.</li> </ul> <p>Any deficiencies in the AI's NPP identified in the review mentioned above are raised to the AI's senior management, and, where appropriate, the Board or Board-level committees, and the AI is required to take timely remedial action. The deficiencies are also reflected into the "Management" component in the annual CAMEL rating review and relevant parts of the Pillar 2 Supervisory Review Process.</p> <p>Although no ex ante approval is required for new products, the BSD does request AIs to submit ex post a list of new products that AIs introduce over a particular period when conducting the annual off-site review. This is an important piece of information to help the BSD in assessing any emerging risks facing the AIs, thus facilitating the setting of the supervisory plan for the AIs concerned.</p>
<b>EC9</b>	<p>The supervisor determines that banks have risk management functions covering all material risks with sufficient resources, independence, authority and access to the banks' Boards to perform their duties effectively. The supervisor determines that their duties are clearly segregated from risk-taking functions in the bank and that they report on risk exposures directly to the Board and senior management. The supervisor also determines that the risk management function is subject to regular review by the internal audit function.</p>
<b>Description and findings re EC9</b>	<p>SPM IC-1 "General Risk Management Controls" provides that:</p> <ul style="list-style-type: none"> <li>• the Board and senior management of an AI should establish a comprehensive and independent risk management function (SPM IC-1 Paragraph 2.1.3);</li> <li>• the risk management function (SPM IC-1 Paragraph 4.1.2 &amp; 4.1.3): <ul style="list-style-type: none"> <li>○ should have clearly defined responsibilities;</li> <li>○ should ensure that all relevant risks of the AI are identified, well understood, and adequately measured and assessed;</li> <li>○ should be given adequate authority, management support and resources to perform its duties, and be staffed by persons with the relevant expertise and knowledge;</li> <li>○ should be supported by an effective management information system;</li> <li>○ should be independent from the risk-taking units and operational units, and have unfettered access to information from these units that is necessary for carrying out its duties;</li> <li>○ should have a direct reporting line to the relevant Risk Management Committee or senior management; and</li> <li>○ should ensure that all identified risk management issues or concerns are promptly reported to the Board and the relevant Risk Management Committee or senior management and should alert the Board and the</li> </ul> </li> </ul>

	<p>relevant Risk Management Committee or senior management to any other matters that may have a significant impact on the AI's financial position and risk profile; and</p> <ul style="list-style-type: none"> <li>• an AI's internal audit function should perform independent periodic checking on whether the risk management system approved by the Board is properly implemented and the established policies and control procedures in respect of risk management are complied with (SPM IC-1 Paragraph 5.2.1).</li> </ul> <p>Moreover, SPM IC-2 "Internal Audit Function" Paragraph 2.4.2 specifies that the responsibilities of the internal audit function should include an independent assessment of the effectiveness of the systems and processes for risk management and control throughout the organization. SPM IC-2 Paragraph 7.2 specifies the scope and means of supervisory assessment in respect of the internal audit function.</p> <p>The BSD collects and reviews the organization chart of an AI to understand if risk management functions are delegated to one or more departments / units independent of front-line business/risk-taking units.</p> <p>Where the AI has no such independent risk management unit(s), the BSD would determine whether this is acceptable taking into consideration the risk profile, size, and complexity of operations of the AI and if there are any alternative mitigating measures. In fact in most cases the HKMA would strongly encourage AIs to set up such risk management unit.</p> <p>Where the AI has set up risk management units, the BSD requires the AI to provide information on the job duties and responsibilities of the staff within the risk management units to ascertain that they are not involved in risk-taking activities. The BSD assesses the staff resources of the risk management units with regard to the scale and complexity of the business and risk level of the AI to ascertain whether there is sufficient manpower and other required resources for proper discharge of the duties of the risk management function.</p> <p>When a risk management unit has been properly established, the BSD would monitor the adequacy and effectiveness of the risk management function (i.e. whether staff within the function are able to perform their roles diligently and independently) on an ongoing basis. Further, BSD verifies the adequacy and effectiveness of the risk management function of AIs during on-site examinations.</p> <p>During the course of on-site examination, the BSD evaluates and verifies whether the dedicated risk management units of an AI effectively carry out the required functions. Through reviewing the internal documents and interviewing the staff working in the risk management units, the BSD determines whether:</p> <ul style="list-style-type: none"> <li>• the risk management staff possess an appropriate level of skills and experience to perform their duties,</li> <li>• the risk management staff possess the required degree of power and authority to discharge their roles and responsibilities effectively,</li> <li>• the risk management units demonstrate ability to form independent views</li> </ul>
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	<p>when they make decisions and recommendations (e.g., whether to approve limit excesses or to order business line to unwind positions), and</p> <ul style="list-style-type: none"> <li>the risk management units have unfettered access to senior management and the Board to perform their duties effectively.</li> </ul> <p>Moreover, in the on-site examination, the BSD collects the internal audit plan and relevant internal audit programs to check whether the risk management units of the AI are subject to regular internal audit with sufficient coverage. The BSD also meets with the internal auditors to seek their views on the resource adequacy, independence, authority and access to senior management of the risk management units within the AI.</p> <p>Any deficiencies relating to the independence, adequacy and effectiveness of an AI's risk management functions identified during off-site reviews or on-site examinations are communicated to the AI's senior management. The AI is required to implement remedial action within a reasonable period of time.</p> <p>The findings and observations are taken into account when the BSD conducts the Pillar 2 Supervisory Review Process and the CAMEL rating review of the AI.</p> <p>When the BSD inspects the AI's risk management functions specifically / as a stand-alone scope in an on-site examination, it must also assess the effectiveness of risk management when it conducts inspection on specific products/business lines. For instance, it must cover the quality of risk management when it examines an AI's residential mortgage business, treasury activities, or securities investment activities, etc. In such examinations, whether the risk management units can perform their roles and responsibilities independently in the AI's conduct of a particular product/business line is rigorously evaluated.</p>
<b>EC10</b>	<p>The supervisor requires larger and more complex banks to have a dedicated risk management unit overseen by a Chief Risk Officer (CRO) or equivalent function. If the CRO of a bank is removed from his/her position for any reason, this should be done with the prior approval of the Board and generally should be disclosed publicly. The bank should also discuss the reasons for such removal with its supervisor.</p>
<b>Description and findings re EC10</b>	<p>As set out in the SPM IC-1 "General Risk Management Controls" Paragraph 4.1.1, AIs should establish a dedicated risk management function to carry out the day-to-day risk management activities across the whole organization. AIs are expected to appoint a CRO to be responsible for the risk management function and only in exceptional cases (e.g., where an AI's size and complexity do not justify an appointment of a CRO) the responsibility of a CRO may be shared by one of the senior executives of the AI (IC-1 Paragraph 4.1.4).</p> <p>The CRO should have sufficient independence and seniority to enable him to challenge an AI's decision-making process. He should be able to communicate directly with senior management and, where appropriate, report to the Board or its designated committee(s) about adverse developments that may not be consistent with the AI's risk appetite and business strategy.</p>

	<p>The CRO should have skills and experience which are relevant and appropriate to the nature and complexity of an AI's business activities, and should play a key role in enabling the Board and senior management to understand the AI's overall risk profile.</p> <p>The Board of an AI is responsible for the appointment and removal of senior management including the CRO (SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" Paragraph 2.5.4). BDR sections 56, 68 and 75 require an AI to include in its annual public disclosures a description of the titles or positions of the members of the senior management who oversee risk management so that the general public will be able to observe changes in the senior management (including the CRO) of the AI.</p> <p>The CRO is considered as a manager as defined in the BO section 2(1). Hence, an AI should notify the MA of the appointment and cessation of appointment of the CRO within 14 days in accordance with the BO section 72B. SPM CG-2 "Systems of Control for the Appointment of Managers" Paragraph 6.1.5 specifies that AIs should inform the HKMA, as soon as practicable, of cases where managers are removed from their positions because of fraud, dishonesty or malpractice. These requirements enable the HKMA to make enquiries (e.g., the reasons) relating to the removal of a CRO if necessary.</p> <p>In practice, local banks and major foreign bank branches have established and maintained a dedicated risk management unit that is overseen by a CRO. For those small AIs with simple organization structure, the HKMA accepts them to appoint other senior management staff (instead of a dedicated CRO) to oversee the risk management functions provided that this arrangement will not compromise the independence and effectiveness of these AIs' risk management functions. There are frequent interactions between the HKMA and the CROs of these AIs. This ensures that the HKMA gets first-hand information about the risk profile and risk management quality of the AIs, and gathers the CROs' views/comments on emerging risks, if any, in the market.</p> <p>Given the seniority and importance of the CRO within the AI, many local AIs do obtain prior consent of the Board (or its specialized committees such as the Nomination Committee or Risk Management Committee), and would make prior notification to the HKMA, of the removal of their CROs.</p> <p>The HKMA will monitor AIs' compliance with the requirements on an on-going basis.</p> <p>Separately, upon becoming aware of the removal and where appropriate, the HKMA would request an exit interview with the CRO to understand the underlying reasons of his departure.</p> <p>In order to further enhance corporate governance and foster the HKMA's oversight on AIs' risk management processes, the HKMA is considering:</p> <ul style="list-style-type: none"> <li>• requiring AIs to report to the HKMA immediately upon becoming aware that the CRO will be removed from his / her position for any reason;</li> </ul>
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	<ul style="list-style-type: none"> <li>formalizing the practice of carrying out an exit interview with the directors and senior management, including the CRO, upon their departure / resignation / removal from their positions; and</li> <li>requiring local AIs to appoint the CRO as a member of the Board of Directors. This requirement would aim to raise the overall profile and status of the CRO within the AI, and ensure the CRO's views / assessment on the risk profile of the AI can be directly heard and discussed at Board level and his performance directly assessed by the non-executive directors of the AI.</li> </ul>
<b>EC11</b>	The supervisor issues standards related to, in particular, credit risk, market risk, liquidity risk, interest rate risk in the banking book and operational risk.
<b>Description and findings re EC11</b>	<p>Since 2001, the HKMA has issued SPM modules on various subjects with a view to making its guidance to AIs more systematic and standardized. The SPM sets out the minimum standards AIs are expected to attain in order to satisfy the requirements of the BO, the HKMA's latest supervisory policies and practices, and recommendations on best practices that AIs should aim to achieve.</p> <p>SPM modules are available on the HKMA's public website. The HKMA aims to issue SPM modules covering key risks and risk management processes. Such modules generally take into account international regulatory and supervisory standards in their preparation, adapted as necessary to local circumstances, as well as any local implementation experience. SPM modules are subject to consultation with the industry prior to issuance.</p> <p>The HKMA also explains or elaborates its supervisory requirements in other forms, such as through supervisor's memos and Questions and Answers. For important and time-critical issues where the HKMA wants to clarify its supervisory stances and requirements promptly and demand AIs' implementation in a timely manner (e.g., the HKMA's stance on AIs' lending to finance companies), or dynamic areas that supervisory requirements may be subject to periodic adjustment from time to time (e.g., the HKMA's requirements on the loan-to-value ratio, and other credit underwriting criteria, in AIs' property lending business), it is the usual practice of the HKMA to issue circular letters to AIs directly, rather than articulating the requirements in an SPM module. This ensures the HKMA's supervisory objectives can be achieved promptly.</p>
<b>EC12</b>	The supervisor requires banks to have appropriate contingency arrangements, as an integral part of their risk management process, to address risks that may materialize and actions to be taken in stress conditions (including those that will pose a serious risk to their viability). If warranted by its risk profile and systemic importance, the contingency arrangements include robust and credible recovery plans that take into account the specific circumstances of the bank. The supervisor, working with resolution authorities as appropriate, assesses the adequacy of banks' contingency arrangements in the light of their risk profile and systemic importance (including reviewing any recovery plans) and their likely feasibility during periods of stress. The supervisor seeks improvements if deficiencies are identified.
<b>Description and findings re EC12</b>	SPM IC-1 "General Risk Management Controls" section 5.4 and SPM OR-1 "ORM" section 8 specify that each AI should have in place formal contingency and business

	<p>continuity plans, having regard to the nature, scale and complexity of its business activities, to ensure that it has adequate contingency arrangements to deal with emergency or crisis situations and can continue to function and meet its regulatory obligations in the event of unforeseen disruption. These plans should be reviewed periodically by the management of the AI to ensure that they are consistent with the AI's current operations and business strategies, and should be tested periodically to ensure that the AI would be able to execute the plans in the event of a severe business disruption.</p> <p>The HKMA has been paying particular attention to AIs' contingency arrangements in response to the following situations which are considered as more critical in nature:</p> <ul style="list-style-type: none"> <li>(i) Major outage or breakdown of IT systems or e-banking services affecting provision of services to customers or other key day-to-day operations of AIs.</li> <li>(ii) Operational incidents which block physical access to key office premises.</li> <li>(iii) Shortage in cash flow and liquidity to meet financial obligations.</li> <li>(iv) Deterioration in financial performance leading to insolvency/impacting viability.</li> </ul> <p>In all the above four situations, the HKMA expects an AI to put in place documented systems and procedures for:</p> <ul style="list-style-type: none"> <li>• the conduct of stress tests regularly for identifying and measuring the AI's vulnerability to these situations</li> <li>• the discussion of the stress test results among senior management and the Board, as appropriate, and the devising of an action plan in response to the stress test results</li> <li>• the monitoring of implementation of the action plan closely when triggered to ensure that the actions taken remain effective, feasible and valid</li> <li>• the availability of clearly defined conditions by reference to which the contingency plan will be triggered in order to respond promptly to the stressed conditions</li> <li>• the setting up of relevant steering committees where the members involved would respond to the incident that has occurred and provide high-level direction during the contingency period to resolve the incident satisfactorily.</li> </ul> <p>The HKMA reviews and assesses the AI's contingency arrangements in the course of its on-going risk-based supervisory process through off-site review and regular on-site examinations.</p> <p>The BSD staff review each AI's disaster recovery plan, business continuity plan and the related policies to determine whether such plans and policies comply with the requirements set out in relevant SPM modules, suit the specific circumstances of the AI concerned, and remain up-to-date.</p> <p>The BSD ascertains whether an AI has established adequate arrangements and prescribed procedures to implement its plans (e.g., the existence of backup facilities, awareness of the relevant personnel regarding their roles/responsibilities during crisis</p>
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	<p>situations, etc.).</p> <p>To enhance prudential supervision, the HKMA also requires AIs to conduct, in the context of ORM, self-assessment on an annual basis (i.e. Supervisory Control Self-Assessment which covers the key requirements of SPM TM-G-2) to ensure adequate and effective contingency plans are in place.</p> <p>Any deficiencies relating to an AI's contingency planning, identified during off-site reviews or on-site examinations, are communicated to the AI's senior management. The AI is required to implement remedial action within a reasonable period of time.</p> <p>The findings and observations are taken into account when the BSD conducts the Pillar 2 Supervisory Review Process and the CAMEL rating review of the AI to assess the AI's overall risk management capabilities.</p> <p>In gauging an AI's capital and liquidity adequacy in the light of stressed conditions, the BSD reviews the internal capital and liquidity adequacy assessment process conducted by the AI and conducts its own top-down stress tests (See also EC 5 above).</p> <p>The HKMA is participating in work designed to ensure that group-level recovery and resolution plans are in place for a number of G-SIBs with significant operations in Hong Kong. The HKMA is a member of the relevant CMGs for these institutions. In this context, the HKMA has collected information and analysis from the local operations of several G-SIBs (in addition to making use of information collected at the group-level).</p> <p>The HKMA also issued a consultation paper to the industry in November 2012 setting out the HKMA's thoughts on the introduction of recovery planning and resolution planning locally. The HKMA is currently engaged in discussions with the industry bodies and proposes to issue a draft SPM module on recovery planning in Q4 2013 for industry consultation. Projected timing is for recovery planning to be introduced in phases, beginning in the first half of 2014 for the most systemically important banks in Hong Kong.</p>
<b>EC13</b>	<p>The supervisor requires banks to have forward-looking stress testing programs, commensurate with their risk profile and systemic importance, as an integral part of their risk management process. The supervisor regularly assesses a bank's stress testing program and determines that it captures material sources of risk and adopts plausible adverse scenarios. The supervisor also determines that the bank integrates the results into its decision-making, risk management processes (including contingency arrangements) and the assessment of its capital and liquidity levels. Where appropriate, the scope of the supervisor's assessment includes the extent to which the stress testing program:</p> <ul style="list-style-type: none"> <li>(a) promotes risk identification and control, on a bank-wide basis</li> <li>(b) adopts suitably severe assumptions and seeks to address feedback effects and system-wide interaction between risks;</li> <li>(c) benefits from the active involvement of the Board and senior management;</li> </ul> <p>and</p>

	<p>(d) is appropriately documented and regularly maintained and updated.</p> <p>The supervisor requires corrective action if material deficiencies are identified in a bank's stress testing program or if the results of stress tests are not adequately taken into consideration in the bank's decision-making process.</p>
<p><b>Description and findings re EC13</b></p>	<p>SPM IC-5 "Stress-testing" reflects the "Principles for sound stress testing practices and supervision" issued by the Basel Committee in May 2009 and relevant observed best practices in stress-testing.</p> <p>IC-5 section 4 sets out the HKMA's supervisory approach for assessing AIs' stress-testing practices, which is consistent with the Basel Committee Principles. The HKMA will regularly evaluate the appropriateness and effectiveness of AIs' stress-testing programs and compliance with the expectations set out in SPM IC-5.</p> <p>Where and when necessary, the HKMA will engage the Board or senior management of an AI to discuss pertinent issues associated with its stress-testing program, or require AIs to conduct additional stress tests.</p> <p>Corrective action by AIs will be required where the HKMA's assessment reveals material shortcomings in an AI's stress-testing program or that its stress-testing results are not adequately attended to or acted upon. The HKMA will expect the AI to provide a detailed plan of corrective actions and follow-up on its implementation (SPM IC-5 Paragraph 4.2.5).</p> <p>During off-site reviews and on-site examinations of an AI, the BSD collects and reviews documentation relating to the stress testing program of the AI, with a view to ensuring that the AI has made full use of stress tests in the business planning process and in the risk management process for all material risks, including but not limited to, capital adequacy assessment, liquidity adequacy assessment, credit risk management, etc.</p> <p>In reviewing the AI's stress testing program, the BSD will assess whether the following practices are adopted by the AI:</p> <ul style="list-style-type: none"> <li>• stress testing is conducted with sufficiency coverage to firm-wide risk profile;</li> <li>• stress testing is used as a tool in the risk management of all material risk areas;</li> <li>• the stress tests adopt reasonably severe assumptions/ scenarios taking into account the nature and complexity of the AI's business. In this regard, the HKMA has stipulated in SPM IC-5 that AIs need to simulate scenarios similar to those experienced in the 1997 Asian Finance Crisis and the 2007 Global Financial Crisis (real case scenarios) in addition to other hypothetical scenarios developed by the AI internally.</li> <li>• the procedures, methodologies and frequency of the stress tests conducted by the AI are such as to ensure the appropriateness and effectiveness of the stress tests.</li> <li>• management meeting minutes demonstrate whether the stress test results are being considered by the AI when establishing and reviewing its policies and limits for risk management.</li> <li>• the AI has set out management alert levels (MAL) which are related to some</li> </ul>

	<p>possible outcomes of the stress tests. When one or more of these outcomes happen(s) under the stress tests, the AI is expected to implement rectification action.</p> <ul style="list-style-type: none"> <li>the stress testing program is subject to regular review by senior management and/or the Board, as appropriate, while the results of each stress test should be submitted to the senior management and/or the Board for deliberation, as appropriate.</li> </ul> <p>Once the adequacy and effectiveness of the AI's stress testing program has been established, the BSD would then focus on the result of individual stress tests conducted by the AI, the implications of the test results for the AI's risk profile, and the usefulness of the actions taken by the AI in response to the test result. In this regard, the BSD reviews regularly, or on a need basis, the stress-testing results of an AI, and, where necessary, discusses the review results with the AI's senior management during prudential meetings.</p> <p>Any deficiencies relating to an AI's stress testing program and any comments relating to the results of the AI's stress tests identified during off-site reviews or on-site examinations are communicated to the AI's senior management. The AI is required to implement actions to address the BSD's concerns within a reasonable period of time.</p>
<b>EC14</b>	The supervisor assesses whether banks appropriately account for risks (including liquidity impacts) in their internal pricing, performance measurement and new product approval process for all significant business activities.
<b>Description and findings re EC14</b>	<p>According to SPM IC-1 "General Risk Management Controls" Paragraph 4.4.2, the performance measurement system for individual business units (including internal pricing mechanisms) used by AIs should be able to comprehensively measure the risks associated with the business activities of the business units. Before the introduction of new products or services, AIs are required to make a detailed risk assessment (SPM IC-1 Paragraph 3.3.4).</p> <p>The internal transfer pricing mechanism of an AI is assessed when the BSD conducts on-site examinations to inspect the treasury function of the AI.</p> <p>In the examination, the on-site examiners review:</p> <ul style="list-style-type: none"> <li>how internal transfer pricing is set and computed (e.g., market-based, cost-based or negotiated) and assess whether such settings are appropriate taking into account the type and nature of the transactions, the internal units involved in the relevant transactions, and the risk and return relationship for funding those transactions.</li> <li>whether the internal transfer pricing models adopted by the AI are properly endorsed by the senior management and, where appropriate, the Board.</li> <li>whether the internal transfer pricing models have been closely observed by the AI or not, and whether exceptions to the models are duly captured, reasonably justified, properly authorized and timely reported to the senior management and the Board.</li> <li>whether the internal transfer pricing models have been subject to regular</li> </ul>

	<p>internal audit, with audit recommendations addressed in a timely manner.</p> <p>With the exception of AIs whose business operations are relatively simple, the HKMA expects that AIs' transfer pricing should take the tenor of the transactions into account, and should be measured on a gross rather than on a net basis so that all tenor mismatches can be centrally managed by the Treasury.</p> <p>With regard to the provision in SPM CG-5 "Guideline on a Sound Remuneration System" that risks should have been properly taken into account when AIs measure the performance of their staff members, the BSD will, during off-site review and on-site examination of an AI:</p> <ul style="list-style-type: none"> <li>• collect documents showing the assessment criteria for the performance of staff at different positions and review whether the criteria include risk-related factors or not;</li> <li>• collect documents and verify whether the assessment criteria have obtained proper endorsement by the Board and/or senior management, as appropriate, or not;</li> <li>• collect the performance appraisal reports of staff in some key positions to verify whether their performance is appraised with due account of risk factors;</li> <li>• collect management reports, submitted to the Board/Board-level specialized committees, showing the progress of the AI in executing the Board-directed risk strategies and appetites, and ascertain whether the reports only focus on financial/business-oriented performance or not;</li> <li>• collect minutes of relevant Board/Board-level specialized committees to ascertain whether the Board/Board-level specialized committees evaluate the AI's senior management based on financial/business-oriented performance solely or have considered risk factors to a substantial extent.</li> </ul> <p>Refer to the responses to EC 8 which detail how the HKMA assesses whether AIs account for risks in their new product approval process.</p> <p>When an AI is assessed to have failed to account for risks properly in its internal transfer pricing, performance measurement and new product approval process for its business activities, the BSD staff would communicate their observations and views to the AI's senior management. The AI would be required to implement remedial actions within a reasonable period of time.</p> <p>The findings and observations would also be taken into account when the BSD conducts the Pillar 2 Supervisory Review Process and the CAMEL rating review of the AI to assess the AI's overall risk management capabilities.</p>
<b>Additional criteria</b>	
<b>AC1</b>	The supervisor requires banks to have appropriate policies and processes for assessing other material risks not directly addressed in the subsequent Principles, such as reputational and strategic risks.
<b>Description and</b>	The HKMA requires AIs to establish a sound and effective system to manage each of



<p><b>findings re AC1</b></p>	<p>the eight inherent risks (viz. credit, market, interest rate, liquidity, operational, reputation, legal and strategic) to which the AIs are exposed (SPM IC-1 “General Risk Management Controls” Paragraph 1.1.3). The risk management policies and procedures of an AI should be developed based on a comprehensive review of all business activities and cover all material risks (SPM IC-1 Paragraph 3.1.2).</p> <p>Under the Supervisory Review Process, the HKMA requires AIs to have a capital adequacy assessment process that addresses all of their material risks, including the eight inherent risks covered under the HKMA’s risk-based supervisory framework, and the interaction of these risks under both normal and stressed conditions, to ensure their capital level is sufficient to cover all the risks undertaken by them (SPM CA-G-5 “Supervisory Review Process” Paragraph 4.3.2).</p> <p>Supervisory requirements in respect of the policies and procedures for managing strategic and reputational risks are set out in SPM SR-1 “Strategic Risk Management” and RR-1 “Reputation Risk Management” respectively.</p> <p>The BSD reviews on an on-going basis the effectiveness of an AI’s risk management processes for controlling material risks within the risk-based supervisory framework outlined in SPM SA-1 “Risk-based Supervisory Approach.”</p> <p>The BSD assesses AIs’ legal, strategic and reputation risk management policies and processes during off-site reviews. The effectiveness of implementation of these policies and processes will then be verified during on-site examinations. Examination checklists are formulated to facilitate the conduct of examinations. The examinations cover, but are not limited to, an assessment of the following areas:</p> <p>Legal risk</p> <ul style="list-style-type: none"> <li>• liabilities of the Board of Directors under the relevant laws and regulations</li> <li>• clear definition of the responsibilities of the compliance functions</li> <li>• procedures to ensure compliance with laws and regulations</li> </ul> <p>Reputation risk</p> <ul style="list-style-type: none"> <li>• procedures to ensure that the AI’s staff follow the code of conduct and the actions taken by the AI if the code is breached by staff</li> <li>• remedial actions if any control weakness is identified</li> </ul> <p>Strategic risk</p> <ul style="list-style-type: none"> <li>• procedures for monitoring of strategic plans set by the Board of Directors</li> <li>• expertise of the senior management</li> <li>• review of strategic decisions made by the Board</li> </ul> <p>In the Pillar 2 Supervisory Review Process, the BSD assesses the adequacy and effectiveness of the risk management systems in respect of reputation risk, legal risk and strategic risk of an AI. A less-than-satisfactory risk management of reputation risk, legal risk and/or strategic risk would translate into a higher requirement on the level of the minimum CAR of the AI through a higher capital add-on.</p>
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	<p>The BSD takes into account an AI's risk management of reputation risk, legal risk and strategic risk when they assess the "Management" component in the CAMEL Rating review. A less-than-satisfactory risk management of reputation risk, legal risk and/or strategic risk would weigh on the "Management" component of the CAMEL Rating, which in turn could lead to an overall downgrade of the composite CAMEL Rating of the AI.</p> <p>Public sentiment in Hong Kong since the Global Financial Crisis has rendered reputation risk management more challenging for AIs. AIs are expected to report any incidents that could have material reputation risk implications/material customer impact to the HKMA on a timely basis. AIs are also required to consider reputation risk when making major business decisions. The BSD makes reference to media reports in seeking to assess how AIs handle incidents with significant reputational risk, particularly the communication strategy deployed by an AI in such circumstances. This can in turn assist the BSD staff to assess the quality of AIs' in managing their reputation risk profile and identify room for improvement. Please refer to the HKMA circular letter dated 22 June 2010 for the HKMA's stance on how AI should respond to incidents with reputation implications/customer impact.</p>
<b>Assessment of Principle 15</b>	Compliant.
<b>Comments</b>	The HKMA has developed a supervisory process that focuses intensely on the risk management standards, policies and procedures at individual AIs. The emphasis on the quality and thoroughness of risk management is reflected in the SPM and guidance notes, the on- and off-site supervisory work, as well as the CAMEL rating process and Supervisory Review Process. The HKMA has been developing specialist teams to ensure that they can adequately assess the risks incurred by banks and act as needed.
<b>Principle 16</b>	Capital adequacy. <sup>42</sup> The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards.
<b>Essential criteria</b>	
<b>EC 1</b>	Laws, regulations or the supervisor require banks to calculate and consistently observe prescribed capital requirements, including thresholds by reference to which a bank might be subject to supervisory action. Laws, regulations or the supervisor define the qualifying components of capital, ensuring that emphasis is given to those elements of capital permanently available to absorb losses on a going concern basis.
<b>Description and findings re EC1</b>	<p><i>Locally incorporated AIs</i></p> <p>Under BO Schedule 7 Paragraph 6(d), an AI incorporated in Hong Kong, in order to continue to meet the minimum criterion for authorization, must, among other things,</p>

<sup>42</sup> The CPs do not require a jurisdiction to comply with the capital adequacy regimes of Basel I, Basel II and/or Basel III. The Committee does not consider implementation of the Basel-based framework a prerequisite for compliance with the CPs, and compliance with one of the regimes is only required of those jurisdictions that have declared that they have voluntarily implemented it.

	<p>have adequate financial resources for its operations and comply with the rules regarding capital requirements made under BO section 97C(1) (i.e. the Banking Capital Rules or BCR).</p> <p>The BCR were developed, and have been continuously updated as appropriate, based on the prevailing capital standards issued by the Basel Committee on Banking Supervision. Hong Kong implemented Basel 2 and Basel 2.5 on 1 January 2007 and 1 January 2012 respectively and commenced the implementation of the first phase of Basel 3 on 1 January 2013, in line with the Basel Committee's timetable.</p> <p>The BCR prescribe the components of capital (BCR Part 3) categorized under Common Equity Tier 1 (CET1) capital, Additional Tier 1 capital and Tier 2 capital, with eligibility conditions specified to ensure loss absorption as detailed in BCR Schedules 4A to 4C.</p> <p>To ensure loss absorption, the HKMA has taken a more conservative stance for certain items recognized as regulatory capital than is required by the Basel standards including requiring AIs to maintain higher quality capital (e.g., in relation to recognition of revaluation reserves and certain deduction items described in greater detail under EC2). CET1 capital consists of shareholders' funds (i.e. issued ordinary share capital, retained earnings and disclosed reserves) with the highest loss absorption power. In line with the Basel Committee standard, only ordinary shares that meet the qualifying criteria set out in BCR Schedule 4A can be counted in the CET1 capital of an AI (all locally incorporated AIs are "joint-stock companies" and hence there is no need in Hong Kong to make provision for other "cooperative" or "mutual" structures) and the inclusion of innovative capital instruments as CET1 capital is not allowed. Inclusion of reserves (i.e. regulatory reserve for general banking risks and those relating to revaluation of land and buildings) are subject to prescribed limits and conditions.</p> <p>The BCR prescribe the minimum CAR (comprising three risk-weighted capital ratios, namely the CET1 capital ratio, Tier 1 capital ratio and Total capital ratio) that a locally incorporated AI must maintain (see BCR sections 3A and 3B) on a standalone basis and on a consolidated basis (see BCR section 3C), the manner in which the CAR is to be calculated, and the actions an AI must take if it fails to comply with the minimum CAR (Pillar 1 measure) applicable to it or to have a CAR that is equal to or more than the ratio specified by the MA in a notice served on the AI under BO section 97F(1) (Pillar 1 plus Pillar 2 add-on) (see BCR section 3D and BO section 97E).</p> <p>Under BO section 97F, the MA may vary any capital requirement rule in the BCR applicable to an individual AI if the MA is satisfied on reasonable grounds that it is prudent to do so taking into account the risks associated with the AI. Under SPM CA-G-5 "Supervisory Review Process", the MA determines the minimum CAR of an individual AI primarily based on the risk assessment conducted under the Supervisory Review Process (i.e. Pillar 2 - identifying risks not adequately covered under Pillar 1 to which the AI is exposed).</p> <p>In short, the key elements of the capital requirements during 2013 to 2015 are summarized in the following table.</p>
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			2013	2014	2015
Minimum capital ratios under BO section 97F	Pillar 1 min. ratios (i.e. the min. ratios prescribed in BCR section 3A / section 3B)	CET1	3.5%	4.0%	4.5%
		Tier 1	4.5%	5.5%	6.0%
		Total	8.0%	8.0%	8.0%
	Pillar 2 capital add-on	Derived from the Supervisory Review Process and apportioned to the CET1, Tier 1 and Total capital ratios according to the three minimum capital ratios on a proportionate basis, in synchronization with the underlying BCR minimum CAR in force during the period. (SPM CA-G-5 Paragraph 3.5.2)			

If an AI contravenes the BCR, the MA may, after discussions with the AI, require the AI to take specified remedial action pursuant to BO section 97E(2). If an AI fails to comply with such a requirement, every director, chief executive and manager of the AI commits an offence under section 97(E)(4). The BCR section 3D requires an AI to immediately notify the MA if it fails to comply with the minimum CAR applicable to it. Every director, chief executive and manager of an AI that fails to so notify the MA commits an offence under BO section 97D(3).

In order to assist AIs in applying the BCR and promote consistency of application among AIs, the HKMA issues and updates, from time to time, supervisory guidance on the technical aspects of the BCR in the form of SPM modules or FAQs.

Following the completion of the legislative process to implement the first phase of Basel 3 capital standards, the MA issued notices to locally incorporated AIs in January 2013 informing them of the capital requirements (Pillar 1 and Pillar 2) applicable to them under Basel 3 in line with the Basel transitional timeframe.

The BSD conducts the Supervisory Review Process on individual locally incorporated AIs as an integral part of the risk-based supervisory process. In the Supervisory Review Process, the BSD assesses to what extent locally incorporated AIs have risk exposures not covered, or not adequately covered, by the framework set out in the BCR for calculating minimum capital requirements in respect of credit, market and operational risks. As a result of the Supervisory Review Process, the MA sets the minimum capital requirements under BO section 97F for individual locally incorporated AIs which will

	<p>usually be higher than the (Pillar 1) levels specified in BCR sections 3A and 3B. There is no upper limit on the minimum capital requirements that may be set under BO section 97F.</p> <p>In determining the Pillar 2 capital requirement (and ultimately the minimum capital requirements under BO section 97F) of a locally incorporated AI under the Supervisory Review Process, the MA takes into account the following common assessment factors (i.e. items (i) to (iv)) and AI-specific assessment factors (i.e. item (v)):</p> <ul style="list-style-type: none"> <li>(i) the level of inherent risks faced by a locally incorporated AI (in particular those risks that are not captured, or not adequately captured, under Pillar 1)</li> <li>(ii) the adequacy of the locally incorporated AI's systems and controls relating to each type of inherent risk;</li> <li>(iii) the locally incorporated AI's capital strength and capability to withstand risk including, where applicable, the effectiveness of its Capital Adequacy Assessment Process;</li> <li>(iv) the adequacy of the locally incorporated AI's corporate governance; and</li> <li>(v) any other factors (risk increasing or risk mitigating) that are specific to the locally incorporated AI concerned.</li> </ul> <p>As stated in SPM CA-G-5 Paragraphs 2.2.4 to 2.2.6, all locally incorporated AIs are currently required to observe three non-statutory trigger ratios that are set at a certain level above each of the three minimum CARs as a cushion to mitigate the risk of breaching the minimum CARs and facilitate supervisory monitoring of any significant deterioration in their capital positions. The trigger ratios of an AI are set taking into account the vulnerability of the AI to the key factors that determine its minimum CAR. These factors may include quality and volatility of earnings, ability to raise capital and quality of the capital planning process.</p> <p>Currently the non-statutory trigger ratios are at least 0.22 percent above the minimum requirement under BO Section 97F (i.e. Pillar 1 plus Pillar 2 add-on) for the CET1 capital ratio, 0.28 percent for the Tier 1 capital ratio, and 0.5 percent for the Total capital ratio. A locally incorporated AI is expected to discuss with the BSD if and when it reasonably anticipates that its CAR will fall to, or below, the trigger thresholds in the foreseeable future.</p> <p>The BSD monitors the CARs, the composition of the capital base, and the credit, market and operational risk exposures of locally incorporated AIs through reviewing information reported by them in the banking return MA(BS)3 on a quarterly basis. Locally incorporated AIs are also expected to discuss with the BSD before including certain items (e.g., term subordinated debt) as capital. The BSD will ensure that such items meet all the prescribed criteria in the BCR (including those relating to loss-absorption). It is the general practice of the MA to commission external auditors' reports, normally once a year,</p> <ul style="list-style-type: none"> <li>(i) under BO section 63(3A) on the adequacy of a locally incorporated AI's systems of control over the compilation of banking returns and over the AI's compliance with statutory requirements (including the minimum capital</li> </ul>
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	<p>requirements);and</p> <p>(ii) under BO section 63(3) on whether the return MA(BS)3 submitted to the MA by the AI has been correctly compiled in all material respects from the AI's books and records.</p> <p><i>AIs incorporated outside Hong Kong</i></p> <p>For AIs incorporated outside Hong Kong, the primary responsibility for supervising their capital adequacy rests with the home supervisors. The MA generally requires an overseas bank operating in Hong Kong to maintain capital levels consistent with the latest applicable capital standards issued by the Basel Committee in order for it to be and remain authorized.</p> <p>The BSD monitors the capital adequacy positions of these banks on an on-going basis (e.g., through their CAMEL rating review, reviews of financial disclosure statements).</p>
<b>EC2</b>	<p>At least for internationally active banks,<sup>43</sup> the definition of capital, the risk coverage, the method of calculation and thresholds for the prescribed requirements are not lower than those established in the applicable Basel standards.</p>
<b>Description and findings re EC2</b>	<p>As mentioned in EC 1, the BCR (including the definition of capital, the risk coverage, the method of calculation and the minimum CAR) were developed to implement the latest Basel Committee capital standards, with some modifications to cater for specific local circumstances and prudential concerns or to address issues where the Basel standards were not sufficiently clear or specific for implementation purposes.<sup>44</sup> Local adaptations of the capital framework have been kept to a minimum, and their development guided by the general principle that any modification should not result in capital requirements lower than those prescribed by the Basel Committee. Main modifications include:</p> <ul style="list-style-type: none"> <li>• for small AIs with simple operations, introduction of a Basic Approach for calculating risk-weighted assets for non-securitization credit exposures, which is basically Basel 1 with modifications to incorporate applicable Basel 2 changes (e.g., credit mitigation treatments). (For further details see Additional Criterion 1);</li> <li>• introduction of a parent bank approach for the calculation of regulatory capital for market risk in respect of an AI that is the local subsidiary of a foreign parent bank, where the latter has adopted a market risk approach which differs from the BCR requirements. However, the use of the parent bank approach is subject to the prior approval of the HKMA and approval will only be granted if the AI</li> </ul>

<sup>43</sup> The Basel Capital Accord was designed to apply to internationally active banks, which must calculate and apply CARs on a consolidated basis, including subsidiaries undertaking banking and financial business. Jurisdictions adopting the Basel II and Basel III capital adequacy frameworks would apply such ratios on a fully consolidated basis to all internationally active banks and their holding companies; in addition, supervisors must test that banks are adequately capitalized on a stand-alone basis.

<sup>44</sup> For instance, Basel 3 requires banks that use the internal ratings-based (IRB) approach for credit risk to take account of the effect of credit risk mitigation in the usual manner when they calculate regulatory capital for credit valuation adjustment and exposures to central counterparties. However, Basel 3 does not provide guidance where the usual IRB treatment does not work (e.g., in respect of recognized collateral), and implementational refinement by national supervisors is necessary in these instances.

	<p>demonstrates to the satisfaction of the MA that using that approach will not materially prejudice the calculation of the AI's market risk capital and, in the opinion of the MA, the parent bank is adequately supervised by its home supervisor in respect of the calculation of market risk. The HKMA intends that such approvals would only be granted on a very exceptional basis and no such approvals have been granted so far;</p> <ul style="list-style-type: none"> <li>• unrealized fair value gains on land and buildings revaluation are only allowed to be recognized in Tier 2 Capital with the application of a 55 percent haircut;</li> <li>• requiring AIs to earmark a certain amount of their retained earnings as a non-distributable regulatory reserve for general banking risks (RR) to cover expected but not yet incurred credit losses (see Principle 18);</li> <li>• full deduction of deferred tax assets net of deferred tax liabilities and mortgage servicing rights for the determination of the capital base; and</li> <li>• introduction of anti-avoidance provisions requiring that any loans, facilities or other credit exposures provided by the institution to any connected company that have characteristics of capital investments should be subject to a similar treatment as capital investments.</li> </ul> <p>The first of the above modifications is only applicable to small, simple, non-internationally active banks (which typically have high capital levels in Hong Kong); the second modification, when applied, should not lead to lower capital requirements than under the applicable Basel standard; and the four last modifications lead to more stringent requirements than the Basel standards.</p> <p>All AIs incorporated in Hong Kong must comply with the BCR. BCR section 3C empowers the MA to require an AI which has one or more than one subsidiary to calculate its CAR – (a) on an unconsolidated basis in respect of the AI; (b) on a consolidated basis in respect of the AI and its subsidiary or subsidiaries; or (c) on both an unconsolidated basis in respect of the AI and a consolidated basis in respect of the AI and its subsidiary or subsidiaries. The consolidation applies to the AI and a subsidiary of the AI (other than a subsidiary which is an insurance firm or security firm) where more than 50 percent of the total assets or total income of the subsidiary relate to, or arise from, the carrying out of one or more than one relevant financial activity (see BCR section 27 for the circumstances under which a subsidiary of an AI will be considered a candidate for consolidation for CAR purposes).</p> <p>As regards consolidation up to the holding company of an AI, the existing requirements are as follows:</p> <ul style="list-style-type: none"> <li>• for a locally incorporated AI that is a subsidiary of a bank or supervised financial institution incorporated outside Hong Kong, the primary responsibility for supervising the capital adequacy of the bank or institution on a full consolidated basis rests with its home supervisor.</li> <li>• for a locally incorporated AI that is a subsidiary of an entity (whether incorporated in or outside Hong Kong) which is not a bank or financial institution subject to prudential regulation, there is no statutory requirement for the calculation of CAR to be extended to such entity on a fully consolidated basis. However, since it is the MA's general policy that a person who intends to</li> </ul>
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	<p>hold 50 percent or more of the share capital of an AI incorporated in Hong Kong should be a well-established bank or other supervised financial institution in good standing in the financial community and with appropriate experience, only a few AIs fall within this category.</p> <p>The capital requirements in Hong Kong are considered not to be lower than those established by the Basel Committee. The MA notified individual locally incorporated AIs in January 2013 of the minimum capital requirements applicable to them under Basel 3.</p> <p>Through off-site review and on-site examinations, the BSD ensures that the approaches adopted by locally incorporated AIs for regulatory capital calculation purposes are appropriate to their business size and risk profile.</p> <p>AIs generally adopt standardized or model-based approaches for calculating their capital charges for credit, market and operational risks. AIs with small, simple and straight-forward business operations, may adopt a simpler approach (i.e. Basic Approach) to calculate their risk exposures after obtaining the approval of the HKMA. As part of its on-going supervisory process, the BSD monitors whether any such AIs continue to meet the criteria for adopting the simpler approach.</p> <p>As regards consolidation up to the holding company of local banks, the HKMA has in Q3 2013 implemented an enhanced framework for the consolidated supervision of banking groups. This enhanced framework is applicable to cases where no holding company of a local bank is a regulated entity.</p> <p>Under the enhanced framework, the ultimate holding company (UHC) of a local bank is generally required to establish a holding company incorporated in Hong Kong (IHC) whose sole purpose is to hold the shares in the local bank (the IHC may however conduct other business or activities if they are for the purposes of providing support to the business or activities of the local bank). This IHC is itself required, by means of the conditions attached to the consent given to it to be / become a majority shareholder controller of a local bank under BO section 70 to observe, on a consolidated basis, prudential standards on capital adequacy as if the IHC were a local bank. (See Principle 12 EC 2 for details.)</p>
<b>EC3</b>	<p>The supervisor has the power to impose a specific capital charge and/or limits on all material risk exposures, if warranted, including in respect of risks that the supervisor considers not to have been adequately transferred or mitigated through transactions (e.g., securitization transactions)<sup>45</sup> entered into by the bank. Both on-balance sheet and off-balance sheet risks are included in the calculation of prescribed capital requirements.</p>
<b>Description and findings re EC3</b>	<p>The MA has discretion under BO section 97F to vary any capital requirement rule applicable to a locally incorporated AI, and this is the mechanism used for</p>

<sup>45</sup> Reference documents: Enhancements to the Basel II framework, July 2009 and: International convergence of capital measurement and capital standards: a revised framework, comprehensive version, June 2006.



	<p>implementing Pillar 2 capital requirements on individual AIs.</p> <p>BCR section 43(1)(f) empowers the MA to require an AI to deduct the amount of any securitization exposure of the AI from the AI's CET1 capital. This power enables the MA to require a securitization exposure to be deducted if the MA considers that the risks associated with the exposure have not been adequately transferred or mitigated through the securitization transaction concerned or the credit protection purchased for the exposure.</p> <p>In extreme situations, the MA could impose limits on specific risk exposures by exercising his supervisory intervention powers under BO section 52(1), after consultation with the FS, if any of the conditions for the use of those powers is present (see Principle 1 EC 3).</p> <p>Apart from the Pillar 1 requirement as stipulated in the BCR, the MA conducts a Supervisory Review Process in accordance with the methodology / approach set out in SPM CA-G-5 "Supervisory Review Process" to assess AIs' capital adequacy and determine if they should hold additional capital to cater for risks that are not covered, or not adequately covered, under Pillar 1 (including all on- and off-balance sheet risks). The Supervisory Review Process will include an assessment of risks not adequately transferred through risk mitigating transactions (e.g., high cost credit protection transactions).</p> <p>Although BO section 97F sets no upper limit for the variation of the minimum CAR of individual AIs, the MA has indicated to the banking industry the MA's intention to continue to calibrate the Pillar 2 capital add-on based on a maximum Pillar 2 capital requirement of 8 percent in respect of the Total capital ratio (SPM CA-G-5 Paragraph 3.3.2). This means that under normal circumstances, the MA could raise an AI's Total capital ratio up to 16 percent. However, if the situation warrants, the MA has the legal power to impose a Total capital ratio on an AI in excess of 16 percent. The MA will review the calibration from time to time to ensure its suitability.</p> <p>As mentioned in EC 1 above, the MA conducts a Supervisory Review Process annually to determine any additional capital that an AI should hold, in the form of a capital add-on (i.e. a "Pillar 2 capital add-on), to cover risks not captured, or not adequately captured, under the framework set out in the BCR for calculating the minimum amount of capital that the AI should maintain in respect of its credit, market and operational risks (i.e. Pillar 1 framework).</p> <p>The BSD, when determining the Pillar 2 capital add-on to be imposed on an AI, takes into account various common assessment factors and AI specific factors.</p> <p>As of 1 January 2013, the Pillar 2 capital add-on for the total capital ratio imposed on locally incorporated licensed banks ranged from 1 percent to 4 percent. For locally incorporated restricted license banks and DTC, the Pillar 2 capital add-on ranged from 1 percent to 8 percent. The range may change from time to time.</p>
<b>EC4</b>	The prescribed capital requirements reflect the risk profile and systemic importance of

	banks <sup>46</sup> in the context of the markets and macroeconomic conditions in which they operate and constrain the build-up of leverage in banks and the banking sector. Laws and regulations in a particular jurisdiction may set higher overall capital adequacy standards than the applicable Basel requirements.
<b>Description and findings re EC4</b>	<p>BO section 97C(3) provides for the rules made under section 97C(1) to make different provisions for different classes of AIs taking into account the risks associated with the AIs belonging to each class; to give effect to the banking supervisory standards related to capital issued by the Basel Committee subject to any modifications the MA thinks fit, having regard to the prevailing circumstances in Hong Kong; and to set capital requirements within a range and prescribe the circumstances under which the MA may determine that a specific capital requirement within that range should apply to an AI. These powers enable the MA to impose capital standards that are higher than the capital standards issued by the Basel Committee, and to impose:</p> <ul style="list-style-type: none"> <li>• countercyclical buffers to reflect markets and macroeconomic conditions; and</li> <li>• higher loss absorbency requirements in the form of capital surcharges to reflect the systemic importance of individual AIs.</li> </ul> <p>As mentioned in EC 3, BO section 97F empowers the MA to vary any capital requirement rule applicable to a locally incorporated AI. BO section 97F was deliberately worded to refer to risks “associated with” an AI to capture both risks run by the AI and risks posed by it (in terms of systemic externalities). The power in BO section 97F enables the MA to require an AI to maintain capital ratios at levels that are higher than those under the capital standards issued by the Basel Committee, set out in BCR sections 3A and 3B, in light of the specific risk profile of the AI.</p> <p>The MA assesses an AI’s capital requirement in accordance with the Supervisory Review Process prescribed in SPM CA-G-5 “Supervisory Review Process” and determines the appropriate level of the Pillar 2 capital requirements that should be imposed on the AI based on the assessment results. The assessment covers, inter alia, the inherent risks associated with an AI, the extent to which such risks are covered, or adequately covered, by the capital requirements set under the BCR, the adequacy of the AI’s systems of controls, the effectiveness of the AI’s Capital Adequacy Assessment Process (CAAP) and its capital strength (in terms of the loss-absorbing quality of the capital instruments issued, the adequacy of provisions for expected loss, access to additional capital and capability to withstand economic cycles and other external risk factors and issues related to the modeling approaches and the AI’s corporate governance together with any specific factors which increase or mitigate risks to the AI. Pursuant to SPM CA-G-5 Paragraph 4.3.4, changes in the AI’s risk profile, including as a result of changes in the overall economic environment, should be promptly incorporated into an AI’s risk measures in its CAAP.</p>

46 In assessing the adequacy of a bank’s capital levels in light of its risk profile, the supervisor critically focuses, among other things, on (a) the potential loss absorbency of the instruments included in the bank’s capital base, (b) the appropriateness of risk weights as a proxy for the risk profile of its exposures, (c) the adequacy of provisions and reserves to cover loss expected on its exposures and (d) the quality of its risk management and controls. Consequently, capital requirements may vary from bank to bank to ensure that each bank is operating with the appropriate level of capital to support the risks it is running and the risks it poses.

	<p>The Supervisory Review Process ensures that all material risks of AIs are reflected in their capital requirements (see also EC 3). The capital requirements imposed by the MA on individual AIs are higher than the applicable Basel requirements.</p> <p>The Supervisory Review Process also assesses the adequacy of an AI's capital position, taking into account the AI's risk profile, quality of its risk management systems and internal controls, the quality of its capital structure (e.g., the proportion of capital base consisting of high loss absorbency capital), the capital planning process and effectiveness of its corporate governance.</p> <p>In line with the Basel 3 implementation timetable, the MA intends to amend the BCRs in 2014 to implement the requirement for AIs to hold additional capital in the form of capital buffers (capital conservation buffer and countercyclical buffer), and higher loss absorbency requirements in the form of capital surcharges for systemically important banks (both global and domestic) in addition to their minimum capital requirements from 1 January 2016.</p>
<b>EC5</b>	<p>The use of banks' internal assessments of risk as inputs to the calculation of regulatory capital is approved by the supervisor. If the supervisor approves such use:</p> <ul style="list-style-type: none"> <li>(a) such assessments adhere to rigorous qualifying standards;</li> <li>(b) any cessation of such use, or any material modification of the bank's processes and models for producing such internal assessments, are subject to the approval of the supervisor;</li> <li>(c) the supervisor has the capacity to evaluate a bank's internal assessment process in order to determine that the relevant qualifying standards are met and that the bank's internal assessments can be relied upon as a reasonable reflection of the risks undertaken;</li> <li>(d) the supervisor has the power to impose conditions on its approvals if the supervisor considers it prudent to do so; and</li> <li>(e) if a bank does not continue to meet the qualifying standards or the conditions imposed by the supervisor on an ongoing basis, the supervisor has the power to revoke its approval.</li> </ul>
<b>Description and findings re EC5</b>	<p>Under the BCR, AIs are required to seek the MA's prior approval for the use of the more advanced approaches for regulatory capital calculation based on their own assessment of risks, demonstrating to the satisfaction of the MA that the conditions and requirements specified for this purpose in the BCR are met. This covers the advanced approaches related to credit risk (IRB), counterparty credit risk (IMM(CCR)) and market risk (IMM). The Advanced Measurement Approaches (i.e. use of internal models generated by banks) for operational risk are not yet available in Hong Kong.</p> <p>Currently, there are 8 locally incorporated AIs (which represent 5 banking groups) adopting the IRB approach for credit risk and 6 locally incorporated AIs (which represent 3 banking groups) adopting the internal models (IMM) approach for market risk. No locally incorporated AI has to date adopted the IMM (CCR) approach for counterparty credit risk.</p>

	<p>AIs intending to adopt any of the advanced approaches are required to submit their application to the HKMA. Upon receipt of the application for the adoption of the IRB approach and / or the IMM approach, the BSD assesses whether the AI can meet the minimum requirements set out in the BCR Schedule 2 and/or Schedule 3 and relevant SPM modules, as appropriate. Such assessment is mainly conducted through the following processes:</p> <ul style="list-style-type: none"> <li>• reviewing the AI's self-assessment report on compliance with the minimum requirements. Such assessment is required to be conducted by parties (e.g., the AI's internal auditors) independent from those in the AI who are involved in the model development or model validation or who are the users of the models. The report should be signed off by the chief executive of the AI.</li> <li>• carrying out on-site examinations covering both the quantitative aspects (e.g., validation on the models) and qualitative aspects (e.g., governance and use of models). The BSD has established a specialist team to carry out validation (IRB validation team).</li> <li>• reviewing the AI's model processes and the underlying assumptions, internal validation conducted by the AI, and the relevant policies and procedures governing the modeling and validation processes including interpretation of validation results and follow-up actions required.</li> <li>• collecting and reviewing records and relevant training materials provided to the AI's senior management to make sure that they are acquainted with the use of the models, including the limitations and risks of using them.</li> </ul> <p>As regards the IMM (CCR) approach, the HKMA has not as yet received any application from an AI. However, it is expected that the assessment processes would be similar to those for the IRB approach / IMM approach.</p> <p>The above assessment will form the basis for the MA to consider whether to approve the AI's application. If the AI fails to comply with substantially all of the minimum requirements, approval of the application would not be granted. In addition, if an AI, which has adopted the IRB and/or IMM approach following approval by the MA, does not continue to meet the qualifying standards or conditions imposed by the MA on an ongoing basis, the MA has the power to revoke its approval. (See below for description of ongoing compliance assessment process.)</p> <p>AIs are required to seek the MA's consent for the making of any material modification to their internal models (including cessation of using such models). The BSD requires AIs to submit the proposed modification together with a report on validation by an independent party (e.g., the AI's internal auditors) to support that the proposed changes are justifiable. Depending on the nature and scale of the proposed modification, the BSD may conduct on-site validation of the proposed modified models.</p> <p>The use of the IRB approach and IMM approach by AIs is subject to ongoing review by the BSD through off-site surveillance and on-site examinations.</p> <p>As part of its monitoring of the usage of the IRB approach by AIs, the BSD reviews an</p>
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internal Report on Analysis of IRB data to (i) monitor the credit risk profiles of AIs adopting the IRB approach and understand how they performed as compared with the industry average and their peers, and (ii) identify possible trends and outliers across AIs, risk components and asset classes. Outliers and abnormal movements are highlighted and further investigated.

For monitoring the usage of the IMM approach, the BSD reviews the number of back-testing exceptions reported in the Return of CAR. Also, as provided in SPM CA-G-3 section 5.3.3, these AIs are required to regularly inform the MA of the results of their internal validation, including back-testing results. As regards stress testing, the AIs are required to provide the MA with a description of the methodology used to determine the scenarios as well as a summary of results derived from these scenarios (SPM CA-G-3 sections C3.1 and C4.1).

The BSD has a dedicated on-site examination team with specialized expertise and capacity to evaluate AIs' internal assessment processes in order to determine that the relevant qualifying standards are met for such internal assessments to be used to calculate regulatory capital requirements and that the AIs' internal assessments can be relied upon as a reasonable reflection of the risks undertaken.

Specifically, the table below sets out the number and nature of examinations conducted by the BSD relating to the review of the use of the IRB approach and IMM approach during 2012:

<b>Nature of examination</b>	<b>2012</b>
Reviews of IRB approach and IMM approach	22
<i>Of which:</i>	15
. Follow-up examination of IRB approach	
. Internal model recognition assessment and review of IMM approach	7

Through on-site examinations, the BSD reviews areas including, but not limited to, redeveloped internal ratings models for specific exposure types or asset classes, parental support framework, first time approvals of models adopted by AIs and post-implementation reviews.

The BSD also conducted an IRB Benchmarking exercise in 2010. The results were shared with the participating banks, highlighting those risk parameters that might have been underestimated when compared with peers.

The MA has the power to impose conditions on approval given to AIs for the use of internal assessments of risk as inputs to the calculation of regulatory capital.

It is also not uncommon for the BSD to require AIs adopting the IRB approach to revise their model parameters or scale up their model outputs so as to ensure that the resulting risk component estimates are sufficiently conservative for regulatory capital calculation purposes. For example, due to the implementation of Basel 3, AIs adopting the IRB approach have been required to map their internal rating scales to those of

	<p>external credit assessment institutions for the calculation of the capital charge for credit valuation adjustment for counterparties without external ratings, and, where appropriate, were required to revise their proposed mapping scheme to make it more conservative.</p> <p>The HKMA revised its market risk capital framework by incorporating the Basel 2.5 enhancements with effect from 1 January 2012. In relation to the IMM approach, the revised framework imposed more stringent modeling requirements and introduced new market risk capital charges compared to the Basel II market risk framework.</p>
<b>EC6</b>	<p>The supervisor has the power to require banks to adopt a forward-looking approach to capital management (including the conduct of appropriate stress testing).<sup>47</sup> The supervisor has the power to require banks:</p> <ul style="list-style-type: none"> <li>(a) to set capital levels and manage available capital in anticipation of possible events or changes in market conditions that could have an adverse effect; and</li> <li>(b) to have in place feasible contingency arrangements to maintain or strengthen capital positions in times of stress, as appropriate in the light of the risk profile and systemic importance of the bank.</li> </ul>
<b>Description and findings re EC6</b>	<p>BO section 97F empowers the MA to vary any capital requirement rule applicable to a locally incorporated AI, including the minimum capital levels set in BCR sections 3A and 3B. Such power enables the MA to require an AI to set capital levels and manage capital in anticipation of possible events or changes in market conditions that could have an adverse effect on the AI. It is also included in the minimum requirements for use of the modeling approaches for credit risk, counterparty credit risk and market risk that the modeling AIs should have a comprehensive stress-testing program with stress tests conducted regularly to assess: (a) the adequacy of the AI's regulatory capital and internal capital for credit risk, counterparty credit risk and market risk, and (b) the AI's ability to withstand any future events or changes in market conditions that might have an adverse effect on the its relevant exposures.</p> <p>BCR section 318(3) further specifies that where the AI's stress-testing results indicate a material shortfall in its comprehensive risk charge for the correlation trading portfolio of the AI, the MA may impose a supplemental capital charge on the portfolio to be added to the AI's market risk capital requirement calculated under its internally developed approach.</p> <p>Supervisory guidance on the conduct of stress-testing in connection with the IMM approach is set out in SPM CA-G-3 "Use of Internal Models Approach to Calculate Market Risk" section 2.8 and Annexes C and E. Specific guidance on stress-testing in respect of counterparty credit risk is set out in SPM CR-G-13 "Counterparty Credit Risk Management" section 4.7 (This SPM module is currently under review to bring it in line with the latest supervisory standards on counterparty credit risk management).</p>

<sup>47</sup> "Stress testing" comprises a range of activities from simple sensitivity analysis to more complex scenario analyses and reverses stress testing.

	<p>The MA has issued SPM CA-G-5 “Supervisory Review Process” under BO section 16(10), which includes requirements on capital planning and contingency capital planning:</p> <ul style="list-style-type: none"> <li>• paragraph 4.2.6 specifies that the Board and senior management of an AI should ensure the availability of internal policies for capital planning and management purposes which meet the prescribed minimum standards, including the setting of capital adequacy goals in relation to the AI’s risk profile and capital targets and measures to be taken in the event capital falls below a targeted level.</li> <li>• paragraph 4.3.1 specifies that an AI should develop a CAAP that is risk-based and forward-looking, with emphasis on the importance of capital planning, management and other qualitative aspects of risk management and controls. The CAAP should also take into account the AI’s strategic plans and how these relate to macroeconomic factors.</li> <li>• section 3.7 and Annex D set out the requirements for an AI to conduct regularly rigorous, forward looking, stress tests that will: (i) assess the potential vulnerability of the AI and alert the AI to adverse unexpected factors which may affect it involving a broad variety of risks and (ii) provide the AI with an indication of how much capital might be needed to absorb losses should a severe stress event occur. The Board and senior management should have active involvement in setting stress-testing objectives, defining scenarios, discussing the results of stress tests, assessing potential actions and making decisions in response to concerns identified. AIs should feed stress-testing results into their capital and liquidity planning processes, and take these results into account when determining the appropriate appetite or tolerance for different types of risk and evaluating the adequacy of their capital and funding sources and when examining future capital resources and liquidity requirements under adverse scenarios in order to ensure that they have the ability to raise funds at a reasonable cost, when necessary.</li> </ul> <p>Scenario testing of IRB systems is essential for an AI to assess its potential vulnerability to stressed business conditions set out in SPM CA-G-4 section 12. In the validation process, the HKMA expects an AI to demonstrate that the stress tests it has conducted are appropriate and effective for assessing the AI’s capital adequacy and ability to withstand the unfavorable impact of stressed business conditions.</p> <p>SPM IC-5 “Stress-testing” also specifies that AIs should develop and maintain a comprehensive stress-testing program that serves the purposes, among others, of providing a forward-looking assessment of an AI’s risk exposures under stressed conditions and enabling the AI to develop appropriate risk-mitigating strategies and contingency plans; evaluating the AI’s existing and potential vulnerabilities on a firm-wide basis and its capacity to withstand stressed situations (in terms of profitability, liquidity and capital adequacy); and feeding into the AI’s capital planning and strategic decision-making processes (SPM IC-5 Paragraphs 1.2.2 and 2.2.1). It also highlights the usefulness of reverse stress-testing in identifying adverse but plausible event(s) that could threaten the viability or solvency of an AI (e.g., events that could lead to a breach of regulatory CARs), and enabling proactive risk assessment and</p>
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	<p>implementation of an appropriate strategy for risk monitoring, prevention and mitigation.</p> <p>The BSD determines whether an AI adopts a forward-looking approach to capital management, sets capital levels and manages available capital in anticipation of possible events or changes in market conditions, and has feasible contingency arrangements through the following means:</p> <p>In its review of an AI's CAAP, the BSD takes into account, among others, the stress testing approach adopted by AI (including the methodologies and assumption used) as well as the AI's projected capital resources and capital requirements under adverse scenarios. The results of stress tests are taken into consideration in performing the Supervisory Review Process to assess the potential vulnerability of an AI to adverse events or other external factors affecting the AI and the need for the AI to hold additional capital for such risk.</p> <p>In addition, AIs using the IRB approach to calculate credit risk or the IMM approach to calculate market risk are required to conduct respectively credit risk and market risk stress tests in compliance with the relevant minimum requirements in the BCR. The BSD reviews the stress-testing results to ascertain whether AIs have sufficient capital to meet the minimum capital requirements in plausible but adverse stressed conditions.</p> <p>The BSD uses the top-down supervisory stress test as a macro-surveillance tool to monitor and assess the risks that the banking sector is exposed to, as well as to identify individual banks' vulnerabilities. The exercise covers all the locally incorporated licensed banks. The relevant stress test is conducted on a quarterly basis with regard to banks' latest capital adequacy positions to assess the resilience of individual banks as well as the banking sector as whole against severe economic shocks.</p> <p>The BSD has also introduced a bottom-up supervisor-driven stress testing (SST) exercise. Locally incorporated retail banks are required to perform their own stress testing based on a uniform set of supervisory stress scenarios designed by the HKMA and to advise the HKMA of the stress test outcome. The first round of the SST exercise was initiated in 2012 and completed in early 2013. The next round of SST exercises will be conducted in 2014.</p> <p>The results of the SST were analyzed to understand the resilience of banks in Hong Kong in terms of capital adequacy. The availability of capital in anticipation of possible events or changes in market conditions was also examined. The program is a forward looking exercise as participating banks are required to also advise their action plan in case there are shortfalls under the stressed scenarios.</p> <p>Meetings and discussions were held with individual banks to articulate BSD's observations and any prudential concerns noted that should be brought to the banks' attention. In case the stress test results suggest a shortfall in a bank's capital adequacy, the BSD will convey its concern to the bank and, where necessary, take supervisory actions (e.g., requiring the AI to reduce its exposure, requiring the bank to develop a plan to strength its capital position). In addition, the results of the stress test would</p>
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	<p>also form part of the input to the Supervisory Review Process which determines the minimum capital adequacy requirement for individual AIs.</p> <p>As part of its on-going supervision, the BSD evaluates the effectiveness of AIs' stress-testing systems during on-site examinations, having regard to factors such as the integration of stress-testing into AIs' capital and liquidity risk management framework. A round of thematic examinations was initiated in early 2013 to gain understanding on the status of AIs in meeting the requirements in SPM IC-5.</p>
<b>AC1</b>	For non-internationally active banks, capital requirements, including the definition of capital, the risk coverage, the method of calculation, the scope of application and the capital required, are broadly consistent with the principles of the applicable Basel standards relevant to internationally active banks.
<b>Description and findings re AC1</b>	<p>As discussed in Essential Criteria 1 to 6, the capital regime and the ongoing authorization criterion in respect of capital adequacy are applicable to all locally incorporated AIs, regardless of whether they are internationally or non-internationally active banks. However, there are some exceptions:</p> <ul style="list-style-type: none"> <li>• under BCR section 7, AIs with total assets (calculated on both a solo and a consolidated basis) of not more than HK\$10 billion may apply to use the Basic Approach to calculate the risk-weighted amount of non-securitization exposures. The Basic Approach is essentially Basel 1 with modifications to incorporate applicable Basel 2 changes (e.g., credit mitigation treatments). AIs applying to use the Basic Approach are also required to demonstrate to the satisfaction of the MA that there is no cause to believe that the use by the AIs of the Basic Approach would not adequately identify, assess and reflect the credit risk of the AIs' non-securitization exposures taking into account the nature of the AIs' business.</li> <li>• AIs (except those that use the Internal Ratings-Based approach to calculate their credit risk) that have negligible market risk exposures and meet the de minimis criteria, as set out in BCR section 22(1) and summarized below, could be exempted from requirements to calculate regulatory capital for market risk under BCR section 17 (exempted AIs): <ul style="list-style-type: none"> <li>○ the AI's market risk positions should never exceed 5 percent (or only sporadically exceed 5 percent and never exceed 6 percent) of its total on-balance sheet and off-balance sheet exposures; and</li> <li>○ the AI's market risk positions should never exceed HK\$50 million (or only sporadically exceed HK\$50 million and never exceed HK\$60 million).</li> </ul> </li> <li>• exempted AIs must not, except with the MA's prior consent, include market risk in the calculation of CAR. The de minimis exemption is subject to the annual review of the MA. The market risk exemption will be revoked under BCR section 23 if the MA is satisfied that the AI no longer meets the de minimis criteria, or if the AI has given notice in writing to the MA (which is a statutory requirement under BCR section 22(4)) that real or intended increase(s) in its market risk positions cause, or may be likely to cause, it to breach the de minimis criteria.</li> </ul>

<b>AC2</b>	The supervisor requires adequate distribution of capital within different entities of a banking group according to the allocation of risks. <sup>48</sup>
<b>Description and findings re AC2</b>	<p>Under BCR section 3C, the MA may require an AI which has any subsidiary to calculate its CAR – (a) on an unconsolidated basis in respect of the AI; (b) on a consolidated basis in respect of the AI and its subsidiary or subsidiaries; or (c) on both an unconsolidated basis in respect of the AI and a consolidated basis in respect of the AI and its subsidiary or subsidiaries.</p> <p>As mentioned in SPM CA-G-5 “Supervisory Review Process” Paragraph 2.6.4, the MA determines the solo and (where applicable) consolidated minimum CAR for each of the locally incorporated AIs within a local banking group based on the respective risk profile of each of the AIs (including the risks posed by their subsidiaries).</p> <p>It is the general practice of the HKMA to require individual locally incorporated AIs to observe statutory and regulatory requirements on both a solo basis and a consolidated basis. The inclusion of the consolidated basis ensures adequate capital for an AI and its subsidiaries.</p> <p>In the case of a banking group which comprises more than one locally incorporated AI, the requirement for each of these AIs within a banking group to observe its own minimum CAR on a solo basis helps ensure adequate distribution of capital among these AIs.</p> <p>The BSD has conducted visitation to 15 AIs since 2011 to obtain an understanding of the AIs’ CAAP and capital planning process in preparation for thematic reviews of the AIs’ CAAP, including the AIs’ processes for consolidated capital and allocation of capital among group members.</p>
<b>Assessment of Principle 16</b>	Compliant.
<b>Comments</b>	The HKMA has adopted the various components of Basel 2, 2.5 and 3 on or ahead of schedule. It has taken a more conservative approach for certain items recognized as regulatory capital than is required by the Basel standards. The HKMA applies both the three Basel ratios (common equity tier 1, tier 1 and total capital) as well as a trigger for each of these ratios on an individual bank basis, taking into consideration the unique characteristics of each institution. Supervisory staff regularly assesses banks’ capital management and planning and uses stress testing to assess the adequacy of capital.
<b>Principle 17</b>	Credit risk. <sup>49</sup> The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk <sup>50</sup>

<sup>48</sup> Please refer to Principle 12, Essential Criterion 7.

<sup>49</sup> Principle 17 covers the evaluation of assets in greater detail; Principle 18 covers the management of problem assets.

<sup>50</sup> Credit risk may result from the following: on-balance sheet and off-balance sheet exposures, including loans and advances, investments, inter-bank lending, derivative transactions, securities financing transactions and trading activities.

	(including counterparty credit risk) <sup>51</sup> on a timely basis. The full credit lifecycle is covered including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios.
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require banks to have appropriate credit risk management processes that provide a comprehensive bank-wide view of credit risk exposures. The supervisor determines that the processes are consistent with the risk appetite, risk profile, systemic importance and capital strength of the bank, take into account market and macroeconomic conditions and result in prudent standards of credit underwriting, evaluation, administration and monitoring.
<b>Description and findings re EC1</b>	<p>Proper management of credit risk is fundamental to the carrying on of an AI's business with prudence and the appropriate degree of professional competence and in a manner not detrimental to its depositors (BO Schedule 7 Paragraph 12). Credit risk management frameworks are also regarded as key systems of control, and AIs are required to have adequate systems of control in place in order to meet the continuing authorization criteria applicable to all AIs (BO Schedule 7 Paragraph 10).</p> <p>Key supervisory requirements for credit risk management are:</p> <ul style="list-style-type: none"> <li>• AIs are expected to have comprehensive credit risk management systems and processes appropriate to the type, scope, sophistication and scale of their operations (SPM CR-G-1 "General Principles of Credit Risk Management" Paragraph 1.1);</li> <li>• As the credit risk management systems and processes are part of an AI's overall risk management framework, the following general requirements that apply to the overall risk management framework also apply to the credit risk management systems and processes: <ul style="list-style-type: none"> <li>○ the Board and senior management of an AI should ensure that an effective firm-wide risk management framework is in place;</li> <li>○ the Board should approve and establish an overall risk strategy including the AI's risk tolerance/appetite;</li> <li>○ an AI should develop risk management policies and procedures that take into account a number of factors including those that reflect the risk profile and systemic importance of the AI, the size, nature and complexity of the AI's business activities, the economic substance of its risk exposures, the results of sensitivity analysis and stress tests, and anticipated external changes such as changes in market conditions; and</li> <li>○ AIs should ensure that they have comprehensive credit risk management systems to ensure that adequate capital resources are available to cover the risk assumed.</li> </ul> </li> </ul> <p>The need for an AI to establish appropriate credit strategies and policies with related procedures, including credit evaluation, approval and review, credit administration, credit measurement and monitoring, problem loan management and independent</p>

<sup>51</sup> Counterparty credit risk includes credit risk exposures arising from OTC derivative and other financial instruments.

	<p>audits, is emphasized and the details are set out in various modules under the SPM (e.g., CR-G-1, CR-G-2 and CR-G-3).</p> <p>The supervisory requirements discussed above are also applicable to counterparty credit risk management.</p> <p>The BSD ensures that AIs have appropriate credit risk management processes to identify, measure, monitor and control credit risk mainly through off-site surveillance, meetings with the Boards, delegated committees and senior management of AIs, and on-site examinations.</p> <p>As part of its off-site surveillance, the BSD acquires an understanding of an AI's risk strategy and credit risk management processes by reviewing various types of information collected from AIs during its ongoing monitoring and the annual off-site review. Apart from prudential returns and surveys, the typical information collected from AIs generally include, among others, (i) risk appetite statements, (ii) budget for credit growth, (iii) key credit policies such as those on large exposures, risk concentration and connected lending, (iv) information package submitted to and / or minutes of the meetings of the Board and delegated committees, (v) selected internal risk management reports, (vi) internal audit reports, and (vii) stress-testing policies and results.</p> <p>Through the review of the above information, the BSD assesses whether an AI's credit risk management processes provide a comprehensive bank-wide view of credit risk exposures and are consistent with its risk appetite, risk profile, systemic importance and capital strength.</p> <p>The BSD regularly meets with the Board or board-level committee (e.g., audit committee and risk management committee) of locally incorporated banks to discuss the HKMA's supervisory assessments of key risks and challenges of the banks, and any supervisory matters of mutual interest. The meetings provide the BSD with a useful platform to discuss with a bank's Board or Board-level Committee members prudential concern on the bank's credit strategies and risk management issues (such as deficiencies in credit risk management and controls and asset quality of the banks).</p> <p>The BSD also conducts regular on-site examinations to evaluate the adequacy and effectiveness of an AI's credit risk management processes. Depending on the scope of the on-site examinations, the on-site examination teams may review one or more parts of the general credit risk management processes of an AI or perform a focused review on particular types of lending activities of the AI (e.g., residential mortgage loans).</p> <p>In the review of an AI's credit risk management process, the on-site examination teams inspect credit risk strategies approved by the Board and consider whether the AI's credit risk management systems are appropriate to its type, scope, sophistication and scale of lending, taking into account the level of systemic importance of the AI and the size, scope and complexity of its lending business. These systems should enable an AI to identify, quantify, monitor and control bank-wide credit risk and to ensure that adequate capital resources are available to cover the risk assumed.</p>
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	<p>The BSD, with the support of other divisions responsible for macroeconomic (Research Department) and macroprudential surveillance (Financial Stability and Surveillance Division), is vigilant to the changes in macroeconomic environment. For example, there has been fast pace of credit growth noted in the recent past amidst the environment of overheated property market and additional quantitative easing by the major developed economies. The BSD has conducted a series of on-site examinations on AIs' credit underwriting standards and asset quality so as to ensure that prudence and compliance with risk appetite are not compromised while AIs pursue higher credit growth.</p>
<b>EC2</b>	<p>The supervisor determines that a bank's Board approves, and regularly reviews, the credit risk management strategy and significant policies and processes for assuming,<sup>52</sup> identifying, measuring, evaluating, monitoring, reporting and controlling or mitigating credit risk (including counterparty credit risk and associated potential future exposure) and that these are consistent with the risk appetite set by the Board. The supervisor also determines that senior management implements the credit risk strategy approved by the Board and develops the aforementioned policies and processes.</p>
<b>Description and findings re EC2</b>	<p>The Board of Directors of an AI is ultimately responsible for approving the AI's credit risk strategies and policies and ensuring that these are appropriate to the business of the AI and observed within the organization. The Board may delegate all or part of its credit authority to the Credit Committee or senior management within the AI but will remain responsible for overseeing the credit risk management.</p> <p>The Credit Committee or senior management is responsible for translating the Board's credit strategy into actual business and for ensuring that necessary credit risk management policies and procedures are established to carry out such business. The credit risk management systems established should enable the AI to identify, quantify, monitor and control credit risk.</p> <p>SPM CR-G-1 Paragraph 3.1.1 specifies that the credit risk strategy and policy should be consistent with the AI's degree of risk tolerance, the level of capital available for credit activities and its credit management expertise.</p> <p>SPM CR-G-1 Paragraph 3.1.2 specifies that an AI's credit risk strategy and policy (including the criteria to be used in approving credit applications) should be subject to periodic review by the Board in the light of the AI's financial results, market conditions, trends and its capital resources.</p> <p>The above requirements also apply to counterparty credit risk (including potential exposures) management.</p> <p>The BSD assesses whether the AIs' credit risk management strategy and credit policies and procedures are approved, and regularly reviewed, by their Boards or delegated</p>

<sup>52</sup> "Assuming" includes the assumption of all types of risk that give rise to credit risk, including credit risk or counterparty risk associated with various financial instruments.

	<p>committees (e.g., risk or credit committee) through off-site surveillance and on-site examinations.</p> <p>As mentioned in EC 1, the BSD collects from AIs various types of information for review during its off-site surveillance process.</p> <p>Through the review of the information package submitted to and / or minutes of the meetings of an AI's Board and delegated committees, the BSD ascertains whether (i) an AI's Board or delegated committees approves, and regularly reviews, the credit risk management strategy and significant credit risk management policies and processes of the AIs and (ii) the risk appetite set by the AI's Board are being complied with.</p> <p>It is also the BSD's practice to conduct off-site review of key credit policies, such as policies on the control of large exposures, risk concentration and connected lending. When reviewing these policies, the BSD pays special attention to whether they are consistent with the risk appetites set by the Board.</p> <p>In addition, for AIs showing high credit growth, the BSD closely monitors their credit growth on a monthly basis to ascertain whether the growth rates are consistent with their credit growth plans / budgets. If the BSD has concern on an AI's growth plan / budget or notices any major variance from the plan / budget, the BSD discusses with the AI to understand the situation and seek justification where appropriate. In particular, the BSD discusses with the AI the adequacy of its capital and liquidity resources to support the credit growth and whether the AI continues to manage credit risk prudently having regard to its risk appetite.</p> <p>Moreover, by reviewing the internal audit reports of an AI, the BSD monitors whether there are any deficiencies identified in relation to its implementation of credit strategy approved by Board and the adequacy of the relevant policies and procedures.</p> <p>The on-site examination teams of the BSD review AIs' credit risk strategies and policies and processes which should encompass target customer segments, underwriting standards, risk mitigation techniques, risk measurement and monitoring, risk mitigation techniques and management reporting systems. The review generally covers the roles of the Board or the Board-level committee in terms of regular review and approval of credit risk strategies and policies (including subsequent revisions).</p> <p>In the review of AIs' credit risk strategies and policies, the on-site examination teams also make cross reference to the composition of their loan portfolios, cap on total loans, ceiling for each type of lending and exposures to industrial sectors so as to ensure that they are consistent with the risk appetite set by the Board and are strictly implemented by the senior management.</p> <p>In the light of increasing growth of non-bank Mainland China exposures of AIs, thematic on-site examinations of AIs' credit growth and non-bank Mainland China exposures are also carried out in order to determine that they are properly governed by the AIs' credit risk management strategies and are in line with their risk appetite.</p>
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	<p>A specialized team of the BSD conducts treasury examinations which cover review of AIs' counterparty credit risk management. The team reviews AIs' risk governance, counterparty risk limits, reporting and monitoring mechanism, measurement methodologies for capturing counterparty exposures and potential future exposures and risk mitigating measures (e.g., netting arrangement) and determines whether they are consistent with the AIs' risk appetites and commensurate with the AIs' risk profiles.</p>
<b>EC3</b>	<p>The supervisor requires, and regularly determines, that such policies and processes establish an appropriate and properly controlled credit risk environment, including:</p> <ul style="list-style-type: none"> <li>(a) a well documented and effectively implemented strategy and sound policies and processes for assuming credit risk, without undue reliance on external credit assessments;</li> <li>(b) well defined criteria and policies and processes for approving new exposures (including prudent underwriting standards) as well as for renewing and refinancing existing exposures, and identifying the appropriate approval authority for the size and complexity of the exposures;</li> <li>(c) effective credit administration policies and processes, including continued analysis of a borrower's ability and willingness to repay under the terms of the debt (including review of the performance of underlying assets in the case of securitization exposures); monitoring of documentation, legal covenants, contractual requirements, collateral and other forms of credit risk mitigation; and an appropriate asset grading or classification system;</li> <li>(d) effective information systems for accurate and timely identification, aggregation and reporting of credit risk exposures to the bank's Board and senior management on an ongoing basis;</li> <li>(e) prudent and appropriate credit limits, consistent with the bank's risk appetite, risk profile and capital strength, which are understood by, and regularly communicated to, relevant staff;</li> <li>(f) exception tracking and reporting processes that ensure prompt action at the appropriate level of the bank's senior management or Board where necessary; and</li> <li>(g) effective controls (including in respect of the quality, reliability and relevancy of data and in respect of validation procedures) around the use of models to identify and measure credit risk and set limits.</li> </ul>
<b>Description and findings re EC3</b>	<p>As set out in the relevant SPM modules (e.g., CG-1, CR-G-1, CR-G-10 and IC-1), an AI should maintain effective systems for managing credit risk, including:</p> <ul style="list-style-type: none"> <li>• having in place a written statement of credit risk strategy and policy;</li> <li>• approval by the Board of key risk management policies and oversight by the Board to ensure that the strategies approved by it are effectively implemented by the senior management;</li> <li>• conduct of independent audits to ensure credit policies and procedures are sound and complied with;</li> <li>• having a credit manual;</li> <li>• credit measurement and monitoring functions performed at different levels within the AI and systems for administering the AI's credit portfolios and</li> </ul>

	<p>conducting the credit review process;</p> <ul style="list-style-type: none"> <li>• comprehensive procedures and adequate information systems for measuring credit risk (including credit risk of off-balance products such as derivatives in credit equivalent terms), with the information systems being able to quantify periodically and efficiently the credit risk faced by the AI, aggregate information in various meaningful ways to facilitate analysis and highlight risk concentrations and produce reports accurately and in a timely manner to senior management and the Board;</li> <li>• risk limits are put in place that are in line with the AI's risk appetite/tolerance and that are suitable to the size and complexity of the AI's business activities as well as the sophistication of its products and services. The AI should ensure that relevant credit staff members fully understand the AI's strategic direction, policies, tolerance of risk and limits;</li> <li>• having in place a clearly defined policy and strategy, documented in writing and approved by the Board (or a Board committee or senior management with delegated authority), for the management of problem credits, and a dedicated unit to handle the recovery and work-out of problem credits; and</li> <li>• internal controls and practices, supported by a management reporting system, to promptly report deviations from policies, procedures, limits and prudential guidelines to the appropriate level of management (also to the Credit Committee, senior management or the Board if the exceptions exceed a certain amount).</li> </ul> <p>Under SPM IC-1 Paragraph 4.3.5, the accuracy and reliability of a risk measurement method or model should be verified against the actual results through regular back-testing. The measurement method or model (including the underlying assumptions) should also be subject to periodic update to reflect changing market conditions.</p> <p>AIs' credit appraisals should require a detailed analysis of the borrowers' or counterparties' financial position and debt-servicing ability, a thorough understanding of their background and the purpose of the credit and an evaluation of the collateral pledged (if any) and credit decisions should be based on rigorous analysis rather than subjective decisions by senior management. SPM CR-G-13 "Counterparty Credit Risk Management" Paragraph 4.3.3 also explicitly specifies that AIs should not rely unduly on external credit assessments and ratings.</p> <p>The BSD regularly assesses whether the AIs have set out and implemented appropriate credit risk management strategies and the related credit risk management policies and processes for assuming credit risk, and whether such policies and processes have established an appropriate and properly controlled credit risk environment through day-to-day supervision, particularly, by conducting on-site examinations of AIs.</p> <p><i>(a) Strategy, policies and processes for assuming credit risk</i></p> <p>The on-site examination teams review AIs' credit policies and processes to ascertain that they are well documented and sound, and cover the following prudent lending practices:</p> <ul style="list-style-type: none"> <li>• clear underwriting criteria for granting credits (background of counterparty,</li> </ul>
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	<p>purpose and structure of credits, and source of repayment);</p> <ul style="list-style-type: none"> <li>• approval procedures for credits and exceptions; and</li> <li>• periodic and independent reviews of credits granted.</li> </ul> <p>The on-site examination teams conduct sample reviews of loan files and meet with relevant staff of the AIs to ascertain that these policies and processes are effectively implemented. When reviewing credit assessments performed by the AIs, the on-site examination teams also assess whether such credit assessments are based on, among other things, the AIs' understanding of the affairs and financial position of their customers without undue reliance on external credit assessments.</p> <p><i>(b) Criteria, policies and process for granting new facilities and renewal of existing exposures</i></p> <p>The on-site examination teams also review credit policy and relevant documents to ascertain that the underwriting criteria for new exposures, renewal of exposures and refinancing exposures are clearly documented, in line with various regulatory requirements and consistent with the AI's risk appetite. Besides, the examinations also evaluate whether credit authorities are suitably assigned to the Credit Committee and individual credit officers and properly documented. The factors to be considered should include the credit experience of individual credit officers and the type of products assigned to them.</p> <p>Sample reviews are performed to ascertain that AIs conduct credit appraisal for loans before approval and the credit appraisal contain information on;</p> <ul style="list-style-type: none"> <li>• the purpose of loan;</li> <li>• credit limit;</li> <li>• terms of repayment or planned repayment schedule;</li> <li>• credit information of borrower;</li> <li>• current financials of borrower;</li> <li>• other related credit facilities from the AI;</li> <li>• valuation of collateral and its validity; and</li> <li>• viability of project for which the loan proceeds are to be used.</li> </ul> <p>Based on sample reviews of loan files, the on-site examination teams assess if the loans were approved by the appropriate level of lending authorities and within the prescribed underwriting criteria.</p> <p><i>(c) Credit administration policies and processes</i></p> <p>Examinations are performed to ascertain whether there are procedures in place for monitoring on an on-going basis the performance of individual accounts and periodic review of the creditworthiness of individual borrowers.</p> <p>On-site examination teams review the policy and relevant documents to ascertain whether there are established policies, systems, procedures and criteria for loan classification and impairment charges and whether these policies, systems, procedures and criteria are consistent with the HKMA's guidelines.</p>
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	<p>The relevant policies and procedures are also reviewed to ensure that proper and effective policies and practices are in place on the monitoring of loans documentation, legal covenants, contractual requirements, collateral and other forms of credit risk mitigation, e.g., guarantee.</p> <p><i>(d) Information system for identifying, aggregating and reporting credit risk exposures</i> Through on-site examinations, there are assessments on whether there are adequate, well-structured management reports to provide the following information timely for analysis of the credit portfolio:</p> <ul style="list-style-type: none"> <li>• size of exposures</li> <li>• exposures to groups of related borrowers</li> <li>• types of products</li> <li>• exposures to economic sectors</li> <li>• geographic exposures</li> <li>• account performance</li> <li>• internal credit ratings</li> <li>• types and coverage of collateral</li> </ul> <p>Examination teams discuss with senior management and relevant credit officers to understand how the reports are used by the Board and senior management.</p> <p><i>(e) Prudent and appropriate credit limits communicated to relevant staff</i> Assessments are conducted to ascertain whether AIs' credit strategies, policies and credit limits have been clearly disseminated to all the relevant parties engaged in the credit process.</p> <p>As mentioned in paragraph (b) above, on-site examination teams also review these credit strategies, policies and credit limits to ensure that they are prudent and appropriate, and consistent with the AIs' risk appetite, risk profile and capital strength.</p> <p><i>(f) Exception tracking and reporting process</i> Reviews are conducted to ascertain whether proper systems are in place to report and escalate exceptions to senior management and the effectiveness of these systems.</p> <p><i>(g) Controls over use of models to identify and measure of credit risk and set limits</i> In Hong Kong, only the more sophisticated AIs, generally those that adopt the internal ratings-based (IRB) approach to credit risk for capital adequacy purposes, use internal models for credit risk management purposes. The supervisory requirements on the use of internal models (including IRB models) to calculate regulatory capital are detailed in Principle 15 EC 6.</p> <p>A specialist IRB on-site examination team within the BSD conducts examinations of the use of internal rating models of the banks concerned. During such examinations, the review generally covers the data used in developing and validating the models to ensure the quality, reliability and relevance of the data used in these processes. The quality control over the data used in the production environment of the rating models is also subject to the on-site review.</p>
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	<p>In addition, the AIs' policies and procedures governing the use and internal validation (including model performance monitoring) of the rating models are subject to detailed review during the on-site examination. Regarding the actual implementation, the quality of the AIs' model development process, internal validation (including the preparation and cleansing of data, analyses conducted (e.g., back-testing) and interpretation of validation results), conceptual soundness and performance of the models, and how the model outputs would be used in the AIs' actual credit risk management process (including limit setting, credit approval and credit risk monitoring / reporting), are also assessed. These reviews are to ensure that these AIs have in place an effective control over the use of models, including the mechanism assuring the continual properness of these models to identify and measure risk.</p>
<b>EC4</b>	<p>The supervisor determines that banks have policies and processes to monitor the total indebtedness of entities to which they extend credit and any risk factors that may result in default including significant unhedged foreign exchange risk.</p>
<b>Description and findings re EC4</b>	<p>According to SPM CR-G-2 "Credit Approval, Review and Records" Paragraph 2.3.1, credit appraisals should entail a careful consideration of a number of factors including the debt-servicing ability of the borrower in both normal and stressful conditions during various stages of the economic cycle. In calculating the debt-servicing ratio, consideration should be given to the service payments due on the borrower's indebtedness to other lenders. SPM CR-G-2 sections 2.10, 3.1 and 3.2 also require AIs to have systems in place for monitoring and periodic review of credits, including the establishment of central liability records to capture the total exposures to each borrower or group of related borrowers to facilitate credit control.</p> <p>The HKMA supports and promotes the sharing of credit data to help AIs to be better informed of the credit positions and performance of their customers and make more accurate assessment of their creditworthiness. The HKMA considers using credit data from a credit reference agency for assessing credit applications and conducting credit reviews as an essential part of an AI's credit management system unless there are satisfactory alternative arrangements for the comprehensive sharing of credit data.</p> <p>SPM TA-2 "Foreign Exchange Risk Management" section 7 specifies that AIs should monitor their borrowers' foreign exchange exposures in recognition that adverse changes in exchange rates could worsen the ability of their borrowers to service their foreign currency obligations; and, as part of the AIs' credit management process, satisfy themselves that those borrowers to which they have extended foreign currency loans have sufficient assets or income streams to service their obligations in that currency. AIs are required to incorporate the monitoring of borrowers' foreign exchange exposures into their credit approval systems.</p> <p>In assessing whether AIs have adequate policies and procedures to ascertain the total indebtedness of the borrowers, the on-site examination teams assess whether exposures to borrowers or groups of related borrowers can be effectively captured by AIs' information systems including central liability records. For example, the on-site examination teams review whether borrowers' exposures are aggregated automatically, and whether such information is updated and generated so that AIs' exposures to borrowers are still within respective counterparty limits or sub-limits</p>

	<p>across the banking group. Moreover, the on-site examinations review whether the AIs' have prescribed policies and procedures on the following:</p> <ul style="list-style-type: none"> <li>• make use of consumer credit data (through a credit reference agency) as fully as possible to assess the total indebtedness of borrowers who are individuals</li> <li>• make use of commercial credit data (through a commercial credit data reference agency) as fully as possible to assess the total indebtedness of borrowers who are small-medium enterprises</li> <li>• analyze the borrowers total indebtedness by collecting and reviewing their financial statements and other available information (e.g., bank statements) where applicable and appropriate</li> </ul>
<b>EC5</b>	The supervisor requires that banks make credit decisions free of conflicts of interest and on an arm's length basis.
<b>Description and findings re EC5</b>	<p>AIs are required to make credit decisions free of conflicts of interest and on an arm's length basis. The requirements are set out in a number of SPM modules.</p> <p>The BSD monitors whether AIs make credit decisions free of conflicts of interest and on an arm's length basis mainly through off-site reviews of their connected lending policies and on-site examination of the relevant control processes.</p> <p>AIs are required to submit their connected lending policy, and any changes thereto, to the HKMA. Upon receipt of any new or revised connected lending policy from an AI, the BSD reviews the policy to ascertain whether it is consistent with the requirements set out in various SPM modules.</p> <p>If the BSD identifies any gaps of the AI's connected lending policy in meeting the relevant requirements, it will require the AI to take immediate rectifying actions, including making revision(s) to the policy and corresponding system changes.</p> <p>The on-site examination teams assess whether an AI's credit initiation (which should be carried out by the front office) is independent of the credit approval and review functions (which should be from part of the middle office) to avoid any potential conflicts of interest. In cases where small lending limits are delegated by AIs to staff in the front office due to operational needs, the on-site examination teams review whether (i) the delegated lending limits to such staff are reasonable and commensurate with the nature of the lending activities and the operational needs of the AIs, and (ii) whether appropriate safeguards (e.g., independent review of credit granted) have been put in place by the AIs to prevent abuse.</p> <p>During the on-site examination, the examination teams also assess whether the AIs' policies and procedures for identifying and approving connected loans are adequate and effective to avoid conflict of interest and to ensure that such loans are granted on an arm's length basis.</p> <p>Also see the responses to Principle 20 regarding transactions with related parties.</p>
<b>EC6</b>	The supervisor requires that the credit policy prescribes that major credit risk

	<p>exposures exceeding a certain amount or percentage of the bank's capital are to be decided by the bank's Board or senior management. The same applies to credit risk exposures that are especially risky or otherwise not in line with the mainstream of the bank's activities.</p>
<p><b>Description and findings re EC6</b></p>	<p>SPM CR-G-2 "Credit Approval, Review and Records" Paragraph 2.1.3 states that the Board of an AI should establish a clear limit structure for credit approval. Normally, the Credit Committee established by the Board will approve loans to large customers, e.g., those with total facilities in excess of 5 percent of the AI's capital base. Lower lending limits could then be delegated to other credit officers or committees. If the AI does not have a Credit Committee, there should be adequate checks and balances to prevent undue reliance on the decisions of a single credit officer. For example, loans approved by an officer should be periodically reviewed by another officer. In addition, loans over a certain amount should be reviewed by the chief executive of the AI and reported to the Board on a regular basis. Credit authority delegated to the Credit Committee and each credit officer should be subject to regular review to ensure that it remains appropriate to current market conditions and the level of their performance.</p> <p>Relevant controls on the approval authority for major credit risk exposures are also recapped in SPM CR-G-8 "Large Exposures and Risk Concentration." It also specifies that the large exposure policy of an AI should cover, among others, the delegation of credit authority within the AI for approving large exposures, and the circumstances in which the established large exposure limits can be exceeded and the party authorized to approve such excesses, e.g., the AI's Board or Credit Committee with delegated authority from the Board.</p> <p>AIs are also expected to exercise due caution in approving credits and investments with higher risk (e.g., transactions arising from new products, lending to highly-leveraged institutions, market-sensitive transactions).</p> <p>The BSD ascertain whether an AI's credit policy clearly prescribes the nature and amount of credit exposures that are to be approved by its Board or senior management mainly through off-site review of the AI's policies on large exposures and risk concentration and on-site examinations.</p> <p>AIs are required to submit their policies on large exposures and risk concentrations and any proposed changes to such policies to the HKMA. Upon receipt of any new policy or proposed change(s) to such policy, the BSD reviews (i) whether the policy or the proposed changes are consistent with the requirements set out in the SPM CR-G-8 and (ii) whether the limits and thresholds established by and the credit authority delegated within the AI are appropriate.</p> <p>If the BSD considers that the AI's policy on large exposures and risk concentration does not meet the relevant requirements or has concerns on the limits, thresholds, and credit authority as set out in the policy, it will require the AI to make necessary revision(s) to the policy and implement corresponding system changes.</p> <p>In the review of AIs' credit risk management processes, the on-site examination teams ascertain whether the Board has set a clear limit structure for loan approval and</p>

	<p>whether large credits to customers, e.g., those with a total facility in excess of 5 percent of capital base, are subject to approval by the Board or Board-level committee.</p> <p>The on-site examination teams assess whether AIs have adequate policies and systems in place for identification of high risk industries and the requirement of higher approval authorities (at Board level or credit committee) for exposures to risky industries. For specialized lending or lending that is not within an AI's normal scope of credit business (e.g., shipping finance, aircraft leasing), the on-site examination teams also review whether the credit authority for approving these types of exposures are delegated to the appropriate level in the organization.</p> <p>To test compliance with the credit authorities, the on-site examination teams conduct review of the relevant loan accounts (large exposures, specialized lending, exposures to high risk industries, etc.) on a sample basis.</p>
<b>EC7</b>	The supervisor has full access to information in the credit and investment portfolios and to the bank officers involved in assuming, managing, controlling and reporting on credit risk.
<b>Description and findings re EC7</b>	<p>Under BO section 63(1), every AI is required to submit to the MA on a regular basis returns showing the assets and liabilities (monthly) and other information (quarterly) of its principal place of business in Hong Kong and all local branches thereof. Moreover, the MA may under BO section 63(2) require an AI to submit (including periodically submit) such further information as he may reasonably require for the exercise of his functions under the BO.</p> <p>In addition to the information gathering powers available under BO section 63, BO section 55 provides that the MA may at any time, with or without prior notice to the AI, examine the books, accounts and transactions of any AI. Every director, chief executive and manager of an AI that, without reasonable excuse, contravenes a requirement to provide any information and documents to the HKMA staff carrying out an examination or investigation under section 55 commits an offence under BO section 56(2).</p> <p>See also Principle 1 EC 5 and Principle 10 EC 7 regarding access to bank staff.</p> <p>For on-site examinations, as they are conducted under BO section 55, the MA has the authority under BO to require AIs to provide information, among other things, on their credit and investment portfolios. The on-site examination team also meets with bank officers involved in assuming, managing, controlling and reporting on credit risk. AIs are generally cooperative in providing the information requested and arranging relevant bank staff to meet with the examiners.</p>
<b>EC8</b>	The supervisor requires banks to include their credit risk exposures into their stress testing programs for risk management purposes.
<b>Description and findings re EC8</b>	SPM IC-5 "Stress-testing" Paragraphs 2.1 and 2.2 specify that AIs should develop and implement a robust and comprehensive stress-testing program that includes all major types of risk to which they are exposed (which, among other things, include credit risk). The stress-testing program should be appropriate to the nature, scale and complexity

	<p>of the AIs' business activities and the risks associated with those activities; consider a spectrum of perspectives and severity levels, possible correlations among risks (particularly between credit risk, market risk and liquidity risk) and feedback effects; be an integral part of the AIs' risk management framework; and feed into the decision-making process of management. Please refer to Principle 15 EC 13 for further information.</p> <p>SPM CR-G-3 "Credit Administration, Measurement and Monitoring" Paragraph 3.3 specifies that stress-testing should be employed to predict how a credit portfolio might respond to different eventualities. Stress-testing should be conducted on the basis of realistic scenarios, with full consideration of the correlation of various risks and the vulnerability of credits. Typical scenarios would include downturns in an industry or the overall economy, liquidity squeezes and adverse market developments or interest rate trends. Reports of the stress-testing outcomes should be reviewed at an appropriately senior level and any necessary action taken (e.g., policy or limit amendments, hedging, exposure reduction and contingency planning).</p> <p>SPM CR-G-13 "Counterparty Credit Risk Management" sets out the guidance on the stress-testing of counterparty credit risk exposures. The stress-testing results should be reviewed periodically by the Board (or its delegated committee) and senior management, and should be reflected in the counterparty credit risk policies and limits set by them.</p> <p>The BSD ascertains whether an AI includes its credit risk exposures into its stress testing programs mainly through off-site surveillance and on-site examination. As part of its off-site surveillance, the BSD generally reviews AIs' information package submitted to Board / Committees (e.g., Risk Committees) or risk management reports to senior management, which include information such as stress tests on credit risks, the scenarios and assumptions adopted in the stress tests, and the respective impact on the AI's individual / entire credit portfolio, earnings and / or capital adequacy positions.</p> <p>Moreover, when assessing the adequacy and effectiveness of AIs' internal capital adequacy assessment processes, the BSD also reviews the stress testing conducted by AIs on capital adequacy. Through the review of the stress testing assumptions and results, the BSD can ascertain whether major types of risks, including credit risk, have been taken into account in the stress testing.</p> <p>The BSD may include AIs' stress testing practices in the scope of risk-based on-site examinations and thematic on-site examinations where appropriate.</p> <p>In the risk-based on-site examinations in 2012, the BSD assessed the adequacy and robustness of the stress-testing conducted by a number of AIs for their credit portfolios, with particular focus on (i) the appropriateness of the assumptions used in the stress-testing (including whether the scenarios adopted are sufficiently stressful) and (ii) the adequacy and effectiveness of the follow-up work on stress test results.</p> <p>In addition, to monitor AIs' progress in meeting the requirements set out in the revised</p>
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	<p>SPM IC-5 on Stress-testing issued in May 2012, the BSD has scheduled a round of thematic examinations on stress testing of selected AIs throughout 2013. The scope of the examinations covers, among other things, the adequacy of risk factors to be stressed as identified by an AI in capturing major risks facing the entity (including credit risk), and whether possible linkages across risks and inter-relationships among risk factors have been taken into account.</p> <p>The BSD has also introduced a bottom-up Supervisor-driven Stress Testing Program where retail banks are required to perform stress testing based on a uniform set of supervisory stress scenarios designed by the HKMA and to advise the HKMA the stress test outcome. The banks are required to include their credit risk exposures into this stress testing program.</p>
<b>Assessment of Principle 17</b>	Compliant.
<b>Comment</b>	The HKMA pays close attention to the credit risk policies and exposures of AIs and initiates discussions with management whenever issues arise. Supervisors conduct regular detailed on-site review of AIs' credit portfolios and require corrective actions on a timely basis if problems are detected. Market and macroeconomic conditions are taken into account when analyzing the credit risk within the banking system. Due to the size of Hong Kong AIs' exposure to residential mortgages and non-bank Mainland China, the HKMA has a system in place to carefully monitor these activities. The HKMA recently revised its reporting requirements for exposures to Mainland China to obtain much more granular information to support in-depth analysis on system-wide and individual AI bases.
<b>Principle 18</b>	Problem assets, provisions and reserves. <sup>53</sup> The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves. <sup>54</sup>
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require banks to formulate policies and processes for identifying and managing problem assets. In addition, laws, regulations or the supervisor require regular review by banks of their problem assets (at an individual level or at a portfolio level for assets with homogenous characteristics) and asset classification, provisioning and write-offs.
<b>Description and findings re EC1</b>	<p>The MA expects all AIs to have formalized and documented policies and procedures for ensuring that the performance of credit exposures are regularly reviewed and monitored and that the adequacy of provisions is periodically assessed. The process should include a system for the classification of credit that conforms to the loan classification framework prescribed by the MA.</p> <p>Detailed guidance on the general standards of credit review, asset classification and provisioning is provided in the relevant guidelines issued by the MA from time to time.</p>

<sup>53</sup> Principle 17 covers the evaluation of assets in greater detail; Principle 18 covers the management of problem assets.

<sup>54</sup> Reserves for the purposes of this Principle are "below the line" non-distributable appropriations of profit required by a supervisor in addition to provisions ("above the line" charges to profit).



	<p><i>Credit risk measurement, monitoring and provisioning</i></p> <p>AIs should maintain adequate information systems for measuring credit risk and for monitoring the condition of individual credits to facilitate identification of problem credits and determination of the adequacy of provisions and reserves. The credit process of AIs should include a middle office that monitors limits and other risk parameters set down by the Board, reviews exception reports and checks that problem accounts are properly graded and provided against. AIs must also establish policies on provisioning (including specific provisions (referred to as individual impairment allowance (IIA) and general provisions (referred to as collective impairment allowance (CIA) under Hong Kong Accounting Standard 39 (HKAS 39)) which ensure that loans are prudently provided for on a timely basis. Provisions should ideally be assessed on a loan-by-loan basis with full provision being made for the likely loss. The level of provisions is determined by the AI in consultation with its external auditors but the HKMA reserves the discretion to intervene where in its opinion the AI is being insufficiently prudent in its approach or is seriously out of line with the provisioning policy of its peers.</p> <p>HKAS 39 Paragraph 58 stipulates that an entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply Paragraph 63 (for financial assets carried at amortized cost), Paragraph 66 (for financial assets carried at cost) or Paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss.</p> <p><i>Managing problem credits</i></p> <p>SPM CR-G-10 requires that AIs should have a clearly defined strategy and policies, and procedures for the management of problem credits, and that credits should be regularly reviewed and promptly downgraded if appropriate so that there is no delay in the referral of problem credits to the problem credit management unit. SPM CR-G-10 section 2 describes the policy and strategy AIs should have for managing problem credits, including (i) a clearly defined policy and strategy approved by the Board, Credit Committee or senior management with delegated authority; and (ii) areas to be covered in the policy such as supervision and monitoring of debt recovery performance and production of relevant management information.</p> <p>AIs should ensure that there is an effective means of identifying problem accounts at an early stage so that corrective action can be taken promptly before the position of these accounts deteriorates further. There should be clear guidelines, criteria and trigger points for identifying and transferring credits to an independent problem credit management unit. Credits should also be regularly reviewed and promptly downgraded if appropriate.</p> <p>The BSD ensures that AIs maintain policies and processes for the effective identification and management of problem assets and for the regular review of problem assets and asset classification, provisioning and write-off through the following supervisory processes and tools:</p>
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	<ul style="list-style-type: none"> <li>• off-site review of information from AIs</li> <li>• external auditors' review</li> <li>• tripartite meetings</li> <li>• on-site examinations</li> </ul> <p>These supervisory processes and tools are elaborated in Essential Criteria 2 to 12.</p>
<b>EC2</b>	<p>The supervisor determines the adequacy of a bank's policies and processes for grading and classifying its assets and establishing appropriate and robust provisioning levels. The reviews supporting the supervisor's opinion may be conducted by external experts, with the supervisor reviewing the work of the external experts to determine the adequacy of the bank's policies and processes.</p>
<b>Description and findings re EC2</b>	<p>Under the BO Schedule 7 Paragraphs 9 and 10, an AI is required to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fail to be discharged by it and for losses that will or may occur, and to have adequate accounting systems and adequate systems of control. Failure to fulfill such criteria constitutes grounds for revocation of the authorization of the AI concerned.</p> <p>The MA is empowered under BO section 55 to examine the books, accounts and transactions of an AI. If necessary, the MA may require an AI under BO section 59(2) to submit a report prepared by an auditor appointed by the AI on such matters as the MA may reasonably require for the exercise of his functions under the BO including a report on the state of affairs or profit and loss of the AI based on an audit of the AI's accounts or on whether or not the AI has in place systems of control that are adequate to enable the affairs, business and property of the AI to be prudently managed and the AI to comply with its duties under the BO.</p> <p>The MA may also require an AI under BO section 63(3A) to submit a report prepared by an auditor of the AI as to:</p> <ul style="list-style-type: none"> <li>• whether the AI has in place systems of control to enable the AI to maintain adequate provision for depreciation or diminution in the value of its assets, for liabilities and for losses; and</li> <li>• if the systems are not adequate, the nature and extent of inadequacies.</li> </ul> <p>Following the adoption of IFRS in HKSAR beginning from 2005, AIs are required to agree with the HKMA to earmark a certain amount of its retained earnings as RR for general banking risks to cover inherent but not yet incurred credit losses. (see the guidance issued in April 2005 by the MA to AIs on the Review on Impact of the New Hong Kong Accounting Standards on Authorized Institutions' Capital Base and Regulatory Reporting Paragraphs 6.2.1 and 6.2.2.)</p> <p>Further guidance on loan classification is provided in the "Guideline on loan classification system" (Appendix 2 of the Completion Instructions for Banking Return Form MA(BS)2A "Quarterly Analysis of Loans and Advances and Provisions", December 2007).</p>

	<p>The BSD assesses the adequacy of AIs' policies and processes for asset classification and provisioning through various supervisory processes and tools.</p> <p>AIs are required to submit the details of their asset classification systems to the BSD for review. Upon receiving the information, the BSD reviews the details of asset classification systems and discusses with the AIs which in turn individually need to agree with the BSD an appropriate method of mapping the internal risk ratings / loan categories under their classification system into the five categories under the HKMA's loan classification system (i.e. Pass, Special Mention, Substandard, Doubtful and Loss). Through this process, the BSD obtains an in-depth understanding on AIs' classification systems and policies.</p> <p>In addition, the BSD collects and reviews banking returns and surveys for off-site monitoring of AIs' assets quality, classification of assets, and provisioning.</p> <p>Where the BSD identifies from its review of these returns or surveys any potential issues concerning loan classification and provision, it raises questions to and follows up with AIs. (See Essential Criteria 6 and 7 for details of the off-site monitoring process).</p> <p>Apart from the banking returns and surveys, it is also the general practice of the BSD to require AIs to provide their Board / Committee meeting minutes and other internal risk management reports, which contain information on loan classification trends and impairment charge levels, for review so as to monitor the AIs' asset quality and provisioning levels and assess the adequacy of its management oversight over problem assets and provisions.</p> <p>The MA generally requires, under BO section 63(3A), local incorporated AIs to submit an external auditors' report annually on:</p> <p>(i) BO section 63(3A)(a)</p> <ul style="list-style-type: none"> <li>• whether, during the financial year, in the opinion of the auditor(s), AIs' internal control systems were adequate to enable, as much as is practicable, the AIs to maintain adequate provision for depreciation or diminution in the value of assets (including provision for bad and doubtful debts), and for actual or potential liabilities and losses; and if the opinion is that those systems were not adequate, the nature and extent of any inadequacies.</li> </ul> <p>(ii) BO section 63(3A)(b)</p> <ul style="list-style-type: none"> <li>• whether it appears to the auditor(s) that AIs have failed to maintain adequate provisions.</li> </ul> <p>The objective of the audit is to assess whether AIs have adequate policies, procedures and controls for assessing the quality of their assets regularly and for establishing adequate provisions for bad and doubtful debts.</p> <p>The BSD reviews the auditors' reports to monitor whether any deficiency is identified in the relevant internal controls, and if so, requires AIs to take timely actions to rectify the</p>
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	<p>issue.</p> <p>The BSD also reviews the auditors' management letters from annual financial audits issued to AIs and discusses any matters of prudential concern contained in the letters, such as any control weaknesses identified in relation to loan classification and provisioning.</p> <p>Tripartite meetings may be held with AIs and their external auditors as one of the elements of HKMA's cooperation with external auditors. Matters discussed typically include areas surrounding asset quality, adequacy of provisioning and valuation methodology for different asset classes.</p> <p>In addition to leveraging on the review performed by auditors, the BSD also examines the loan classification and provisioning system of AIs through on-site examinations. In determining the scope of the examination, the BSD takes into account the risk profile of AIs, the findings contained in the external auditors' reports, and other relevant information collected during its on-going supervision.</p>
<b>EC3</b>	The supervisor determines that the bank's system for classification and provisioning takes into account off-balance sheet exposures. <sup>55</sup>
<b>Description and findings re EC3</b>	<p>SPM CR-G-1 "General principles of Credit Risk Management" Paragraph 5.2.1 specifies that AIs should maintain comprehensive procedures and adequate information systems for measuring credit risk (including measuring credit risk of off-balance sheet products such as derivatives in credit equivalent terms) and for monitoring the condition of individual credits to facilitate identification of problem credits and determination of the adequacy of provisions and reserves.</p> <p>The "Guideline on Loan Classification System", which is specified in Appendix 2 of the Completion Instructions for Banking Return Form MA(BS)2A "Quarterly Analysis of Loans and Advances and Provisions" (December 2007), refers to the following:</p> <ul style="list-style-type: none"> <li>• in Paragraph 2, that the HKMA's 5-grade loan classification framework covers loans and advances and other types of on- and off-balance sheet exposures, including balances due from banks, investment debt securities, acceptances and bills of exchange held, accrued interest receivable and commitments and contingent liabilities.</li> <li>• in Paragraph 12, that loan loss provisions should be established and maintained at a level that is adequate to absorb estimated inherent losses in the institution's loan portfolio, binding commitments and contingent liabilities.</li> </ul> <p>The Completion Instructions for Banking Return Form MA(BS)2A "Quarterly Analysis of Loans and Advances and Provisions" (December 2007), Paragraphs 7.6 and 7.7 require AIs to report provisions on commitments and contingent liabilities which subject the</p>

<sup>55</sup> It is recognized that there are two different types of off-balance sheet exposures: those that can be unilaterally cancelled by the bank (based on contractual arrangements and therefore may not be subject to provisioning), and those that cannot be unilaterally cancelled.

	<p>reporting institution to credit risk. These include direct credit substitutes (such as guarantees and standby letters of credit), trade-related contingent items (such as letters of credit and liabilities under acceptances) and irrevocable loan commitments. The definitions of “direct credit substitutes” and “trade-related contingency” items are provided in BCR section 2.</p> <p>The BSD determines whether AIs’ systems for classification and provisioning takes into account off-balance sheet exposures through the supervisory processes and tools described in EC 2.</p>
<b>EC4</b>	<p>The supervisor determines that banks have appropriate policies and processes to ensure that provisions and write-offs are timely and reflect realistic repayment and recovery expectations, taking into account market and macroeconomic conditions.</p>
<b>Description and findings re EC4</b>	<p>Under SPM CR-G-1 “General Principles of Credit Risk Management”:</p> <ul style="list-style-type: none"> <li>• paragraph 5.4.1 – AIs should establish policies on provisioning which ensure that loans are prudently provided for on a timely basis.</li> <li>• paragraph 5.4.2 – provisions should ideally be assessed on a loan-by-loan basis with full provision being made for likely loss. The level of provisions is normally a matter for an AI to determine in consultation with its external auditors but the HKMA reserves the discretion to intervene where in its opinion the AI is being insufficiently prudent in its approach or is seriously out of line with the provisioning policy of its peers.</li> <li>• paragraph 5.4.4 – provisions will comprise specific provisions (referred to as individual impairment allowance under HKAS 39) and general provisions (referred to as collective impairment allowance under HKAS 39). AIs should provide specifically for credits where losses are certain or likely. The percentage to be provided will depend on the particular circumstances.</li> </ul> <p>Following the adoption of International Financial Accounting Standards in Hong Kong beginning from 2005, AIs are required to earmark a certain amount of their retained earnings as a regulatory reserve (RR) for general banking risks to cover expected but not yet incurred credit losses. There is a conceptual difference between the accounting concept of provisions under HKAS 39 and that for regulatory purposes, with the former taking into account only past events (i.e. an incurred loss model). In this context, the RR is a supervisory tool to bridge the gap between the accounting and regulatory concepts of provisioning and help neutralize the effect of accounting changes on AIs’ provisioning levels. The requirement for a RR arises from BO Schedule 7 Paragraph 9 (see guidance to AIs Paragraph 6.2.1). Hence, the MA requires AIs to hold a RR in excess of accounting provisioning in this context. AIs need to agree with the MA on the level of RR required having regard to individual AI’s risk profiles.</p> <p>The BSD determines whether AIs have appropriate policies and processes to ensure that timely and adequate provisions and write-offs are made. The BSD monitors the adequacy of AIs’ provisioning levels (including write-off) by reviewing banking returns and surveys submitted by AIs and conducting analysis of data contained therein. Through these reviews and analysis, the BSD identifies outliers in terms of the timeliness and adequacy of provisions (see EC 7 for details of analysis conducted).</p>

	<p>As mentioned in EC 2, external auditors' reviews generally cover the procedures for reviewing and setting aside general provisions (or CIA) and specific provisions (or IIA) on a regular basis. In addition, auditors are required to report any failure by AIs to maintain adequate provisions.</p> <p>During on-site examinations, the BSD reviews the adequacy of AIs' provisioning and write-off policies and processes. It also assesses, through sampling review and back-testing, the adequacy and timeliness of the provisions (including write-offs) made.</p>
<b>EC5</b>	<p>The supervisor determines that banks have appropriate policies and processes, and organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past due obligations. For portfolios of credit exposures with homogeneous characteristics, the exposures are classified when payments are contractually in arrears for a minimum number of days (e.g., 30, 60, 90 days). The supervisor tests banks' treatment of assets with a view to identifying any material circumvention of the classification and provisioning standards (e.g., rescheduling, refinancing or reclassification of loans).</p>
<b>Description and findings re EC5</b>	<p>Detailed guidance on the management of problem credits is included in the SPM CR-G-10 "Problem Credit Management." Among other things, the following is expected from AIs:</p> <ul style="list-style-type: none"> <li>• paragraph 2.1: AIs should have a clearly defined policy and strategy for the management of problem credits, covering inter alia authorities and responsibilities, monitoring, review, collection, restructuring and work-outs, and management of repossessed collateral.</li> <li>• paragraph 3.1: The level of sophistication of an AI's problem credit management function should be commensurate with its scale of operation and the size, complexity and severity of its problem credits.</li> <li>• paragraph 3.3: AIs should ensure that there is an effective means of identifying problem accounts at an early stage so that corrective action can be taken promptly. AIs should ensure that credits are regularly reviewed and promptly downgraded if appropriate so that there is no delay in the referral of problem credits to the problem credit management unit. Once an account is referred to the problem credit management unit, there should be a structured process for reviewing it and assessing the best way to handle it.</li> </ul> <p>The effect of payment arrears on classification is taken into account by the Completion Instructions for Banking Return Form MA(BS)2A Appendix 2 "Guideline on loan classification system." In terms of overdue period, loans should in general be at least classified as:</p> <ul style="list-style-type: none"> <li>• Special Mention: repayment of principal and/or interest has been overdue for up to 3 months unless fully secured.</li> <li>• Substandard: repayment of principal and/or interest has been overdue for more than 3 months and not fully secured, or, even if fully secured, overdue for more than 12 months.</li> <li>• Doubtful/Loss: repayment of principal and/or interest has been overdue for</li> </ul>

	<p>more than 6 months and not fully secured.</p> <p>Completion Instructions for Banking Return Form MA(BS)2A Appendix 2.1 "Guidelines on overdue and rescheduled assets" contains guidance to prevent the evergreening of assets:</p> <ul style="list-style-type: none"> <li>• paragraph 6: An institution should not extend a new loan to a borrower solely for the purpose of repaying an existing overdue loan with the institution. Where the repayment whether partial or whole is financed by a new loan extended by the institution, the overdue status of the initial loan should be considered as unchanged, i.e. as if the new loan and partial repayment had never been made.</li> <li>• paragraph 8: Rescheduled assets refer to loans and other assets that have been restructured and renegotiated between the reporting institution and the borrower because of a deterioration in the financial position of the borrower or of the inability of the borrower to meet the original repayment schedule and for which the revised repayment terms, either of interest or of repayment period, are 'non-commercial' to the bank. A rescheduled asset will normally require an adverse classification under the loan classification system (i.e. substandard or doubtful).</li> <li>• paragraph 9: For rescheduled assets to cease being considered as such, it is required that: (i) their revised repayment terms are, or become, commercial to the institution; (ii) there is reasonable assurance that the borrowers will be able to service all future principal and interest payments on the assets in accordance with the revised repayment terms; and (iii) the borrowers have serviced all principal and interest payments on the assets in accordance with the revised repayment terms continuously for a reasonable period (6 months for rescheduled assets with monthly payments of both interest and principal, 12 months for other rescheduled assets).</li> </ul> <p>In practice, the BSD determines that AIs have appropriate policies and processes, and organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting past due obligations.</p> <p>As mentioned in EC 2, individual AIs have to discuss and agree with the BSD an appropriate method of mapping the internal risk ratings / loan categories under their classification system into the five categories under the HKMA's loan classification systems. The BSD assesses whether AIs' classification systems for portfolio of credit exposures with homogeneous characteristics are appropriate.</p> <p>The BSD, through the review of banking returns and surveys and analysis of the data contained therein, identifies (i) unusual trend or variance of classified loans and rescheduled loans, (ii) reclassification of major classified assets, and (iii) classification and provision outliers. This off-site monitoring process assists the BSD to identify cases of potential circumvention of the classification and provisioning standards that warrant further review and investigation (see EC 7 for details).</p> <p>As mentioned in EC 2, the objective of the audit under BO section 63(3A)(a) is to assess</p>
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	<p>whether AIs have adequate policies, procedures and controls for assessing the quality of their assets regularly and for establishing adequate provisions for bad and doubtful debts. The auditor is also required to report on any failure to maintain adequate provisions. The auditors would generally conduct sample reviewing to see if there is any major deviation from standards during the audit.</p> <p>Depending on the scope of the examination, the BSD reviews the structure and resources of the departments / units responsible for early identification of deteriorating assets, ongoing oversight of problem assets, and collecting on past due obligations. It also reviews the relevant policies and conducts sampling review to ascertain whether they are adhered to and identify any material circumvention of classification and provisioning standards.</p> <p>For example, in view of the rapid credit growth in Hong Kong in recent years, the BSD conducted a round of thematic examinations on credit growth in 2012 covering, among other things, (i) whether AIs have effective controls and procedures for identifying and reporting problem loans, emerging risk and vulnerabilities in a particular counterparty, economic sector, and (ii) the effectiveness of any follow-up work undertaken by the AI to mitigate potential losses.</p> <p>During the on-site examination, the BSD selects samples with higher possibility of circumvention of classification and provisioning standards, such as restructured loans, refinanced loans, loans that were reclassified as performing, and loans that were on the AIs' recent internal watch lists. This assists the BSD to identify material circumvention of classification and provisioning standards through the sampling review.</p>
<b>EC6</b>	<p>The supervisor obtains information on a regular basis, and in relevant detail, or has full access to information concerning the classification of assets and provisioning. The supervisor requires banks to have adequate documentation to support their classification and provisioning levels.</p>
<b>Description and findings re EC6</b>	<p>SPM CR-G-3 Paragraph 3.1.2 specifies that AIs should have documented systems, procedures and processes for monitoring regularly the performance, quality and condition of individual credits and of the overall portfolio.</p> <p>According to SPM IC-1 "General Risk Management Controls" Paragraph 5.1, there should be a properly structured internal control system to provide reliable financial information. To comply with this requirement, AIs are expected to have adequate documentation to support the loan classification and provisioning level.</p> <p>Under SPM CR-G-2 "Credit Approval, Review and Records" Paragraph 4.2.9, AIs are recommended to include details of assessment and justifications of internal credit rating and provisions of credit facilities in the credit files.</p> <p>As mentioned in EC 2, the BSD collects and reviews various banking returns and surveys for off-site monitoring of an AI's asset quality, classification of assets, and provisioning. Banking Return Forms MA(BS)2A "Quarterly Analysis of Loans and Advances and Provisions" and MA(BS)2AH "Monthly Return on Asset Quality" provide</p>



	<p>the primary sources of data in relation to asset classification and provisions.</p> <p>In addition to the provisions set aside for each classification category, the two returns also contain information on each of the 10 largest exposures (in the case of Banking Return Form MA(BS)2A) or 30 largest assets (in the case of Banking Return Form MA(BS)2AH) under each classified category showing the names of customers, the amount of credit exposures with breakdown by on-balance sheet exposures and commitments &amp; contingencies, the value of security and the provisions made.</p>
<b>EC7</b>	<p>The supervisor assesses whether the classification of the assets and the provisioning is adequate for prudential purposes. If asset classifications are inaccurate or provisions are deemed to be inadequate for prudential purposes (e.g., if the supervisor considers existing or anticipated deterioration in asset quality to be of concern or if the provisions do not fully reflect losses expected to be incurred), the supervisor has the power to require the bank to adjust its classifications of individual assets, increase its levels of provisioning, reserves or capital and, if necessary, impose other remedial measures.</p>
<b>Description and findings re EC7</b>	<p>Under BO Schedule 7, Paragraphs 9 and 10, AIs are required to maintain adequate provisions for depreciation or diminution in the value of their assets (including for bad and doubtful debts), for liabilities which will or may fail to be discharged by them and for losses that will or may occur, and to have adequate accounting systems and adequate systems of control. Any failure to adhere to these requirements (e.g., as reflected by poor asset quality and inadequate provision) may call into question whether the AIs concerned continue to satisfy the relevant minimum authorization criteria under the BO. This would then be a ground for revocation under the BO Schedule 8 Paragraph 2 and BO section 22(1).</p> <p>The following paragraphs of the SPM CR-G-1 "General Principles of Credit Risk Management" specify that:</p> <ul style="list-style-type: none"> <li>• paragraph 5.4.1 – AIs should establish policies on provisioning which ensure that loans are prudently provided for on a timely basis.</li> <li>• paragraph 5.4.2 – provisions should ideally be assessed on a loan-by-loan basis with full provision being made for likely loss. The level of provisions is normally a matter for an AI to determine in consultation with its external auditors but the MA reserves the discretion to intervene where in its opinion the AI is being insufficiently prudent in its approach or is seriously out of line with the provisioning policy of its peers.</li> <li>• paragraph 5.4.4 – provisions will comprise specific provisions (or IIA) and general provisions (or CIA). AIs should provide specifically for credits where losses are certain or likely. The percentage to be provided will depend on the particular circumstances. Following the adoption of IFRS in HKSAR beginning from 2005, AIs are required to agree with the HKMA to earmark a certain amount of its retained earnings as RR to cover inherent but not yet incurred credit losses.</li> </ul> <p>AIs will generally follow the HKMA's instructions to increase the level of RR based on an assessment of the overall adequacy of accounting provisions. However, in the</p>

	<p>extreme, if the problems in the loan classification and provisioning system of an AI cause the MA to opine that the AI is carrying on its business in a manner detrimental to the interests of its depositors, potential depositors, creditors or that the AI has contravened BO Schedule 7 Paragraph 9 which requires the AI to maintain adequate provision for bad and doubtful debts, the MA, after consultation with the FS, may exercise the powers given to him under BO section 52.</p> <p>The BSD assesses whether AIs' classification of assets and provisioning is adequate for prudential purposes through the supervisory processes / tools described in EC 2.</p> <p>Based on the data contained in Banking Return Forms MA(BS)2A and MA(BS)2AH, the BSD conducts variance / trend analysis, checking against provisioning benchmarks, and peer group comparison for identifying classification outliers. The BSD makes use of internal Management Information System reports (e.g., Monthly Asset Quality Survey Results, Risk-Based MIS Reports, Key Indicators, Exception Report etc.) to assist such analysis.</p> <p>Generally, in reviewing the returns or conducting the analysis, the BSD pays special attention to:</p> <ul style="list-style-type: none"> <li>• the trend of classified loans and rescheduled loans,</li> <li>• the reclassification of large classified loans, and</li> <li>• key ratios / indicators (such as coverage ratio of classified loans, provisions to total loans ratio, provisions to net-charge-off ratio, net charge-off to average loans ratio etc.).</li> </ul> <p>The BSD may require AIs to provide explanation for any major unusual trend, variance or reclassification identified. The HKMA may also ask AIs to provide additional information such as internal reports on loan classification and loan provisioning for review.</p> <p>If the BSD is of the view that AIs' asset classifications are inaccurate or provisions are deemed to be inadequate for prudential purposes, the BSD / MA may take one or more of a range of supervisory actions.</p> <p>If the situation deteriorates significantly and AIs are not capable of implementing the necessary remedial actions within a reasonable period, the MA will consider the need for more serious supervisory measures to be taken.</p>
<b>EC8</b>	<p>The supervisor requires banks to have appropriate mechanisms in place for regularly assessing the value of risk mitigants, including guarantees, credit derivatives and collateral. The valuation of collateral reflects the net realizable value, taking into account prevailing market conditions.</p>
<b>Description and findings re EC8</b>	<p>The SPM CR-G-1 "General Principles of Credit Risk Management", specifies the following:</p> <ul style="list-style-type: none"> <li>• paragraph 6.3.4: when the mitigation arrangements are in place they should then be controlled. AIs should have written policies, procedures and controls</li> </ul>

	<p>for the use of credit mitigation techniques. They should also ensure adequate systems are in place to manage these activities.</p> <ul style="list-style-type: none"> <li>• paragraph 6.3.5: AIs should revalue their collateral and mitigation instruments on a regular basis. The method and frequency of revaluation depends on the nature of the hedge and the products involved. The mitigation instruments include standby letters of credit, guarantees, credit derivatives and other hedging instruments (Paragraph 6.3.1).</li> </ul> <p>Under the SPM CR-G-7 “Collateral and Guarantees”, AIs are expected to, inter alia:</p> <ul style="list-style-type: none"> <li>• set up appropriate systems and controls for the management of collateral and guarantees (Paragraph 1.4);</li> <li>• review the financial strength of the guarantors where appropriate (Paragraph 3.2.3) and ensure that the guarantees held remain effective until the facilities covered by the guarantees are fully repaid (Paragraph 3.2.1); and</li> <li>• conduct regular revaluation of the collateral though the frequency may vary with the type of collateral involved and the nature and the internal credit rating of the underlying credit (Paragraph 6.3.1).</li> </ul> <p>SPM CR-G-7 Paragraph 6.1.6 specifies that a discount should be applied to the estimated market value of the collateral for problem credits where appropriate to reflect more closely what may eventually be realized from an asset sale under unfavorable market conditions.</p> <p>Moreover, SPM CR-G-7 Paragraph 6.5 specifies that AIs should monitor general trends in markets for the major types of collateral taken and conduct stress-tests and scenario analysis on their portfolio of collateral in order to assess the impact on collateral value under unusual market conditions.</p> <p>With respect to credit derivatives as a risk mitigant, BCR section 99 sets out the criteria for recognition of credit protection for capital adequacy purposes and SPM CR-G-12 “Credit Derivatives” section 6 provides the treatment of credit derivatives in the reporting of large exposures (SPM CR-G-12 is under review in order to incorporate, among other things, assessment factors that should be taken into account when using credit derivatives as a risk mitigants for general purposes). SPM CR-L-2 “Exemption of Financial Exposures”: section 81(6)(b)(i) sets out the criteria against which the MA will exercise the discretion whether to accept specific types of collateral and guarantees for exempting financial exposures under BO section 81(6)(b)(i).</p> <p>The BSD determines whether AIs have appropriate mechanisms in place for regularly assessing the value of risk mitigants mainly through external auditors’ review and on-site examinations.</p>
<b>EC9</b>	<p>Laws, regulations or the supervisor establish criteria for assets to be:</p> <ul style="list-style-type: none"> <li>(a) identified as a problem asset (e.g., a loan is identified as a problem asset when there is reason to believe that all amounts due, including principal and interest, will not be collected in accordance with the contractual terms of the loan</li> </ul>

	<p>agreement); and</p> <p>(b) reclassified as performing (e.g., a loan is reclassified as performing when all arrears have been cleared and the loan has been brought fully current, repayments have been made in a timely manner over a continuous repayment period and continued collection, in accordance with the contractual terms, is expected).</p>
<p><b>Description and findings re EC9</b></p>	<p>According to SPM CR-G-1 "General Principles of Credit Risk Management" Paragraph 5.3.1, AIs are required to ensure that the loan portfolio is properly classified and have an effective early warning system for problem loans.</p> <p>Under SPM CR-G-10 "Problem Credit Management", AIs are expected inter alia:</p> <ul style="list-style-type: none"> <li>• to have in place an effective means of identifying problem accounts (Paragraph 3.3.1)</li> <li>• to have clear guidelines, criteria and trigger points for identifying and transferring credits to the problem credit management unit, e.g., (i) when a credit has been classified as Substandard or worse; (ii) when the overdue period of a credit exceeds a certain threshold and after initial warnings have been given but to no avail; and (iii) in the case of Special Mention accounts which are significant in balance and more complicated to handle (Paragraph 3.3.2); and</li> <li>• not to extend or restructure a problem credit without an adequate assessment of the extension or restructuring proposal and the longer-term viability of the borrower (Paragraph 3.4.3) and, where additional collateral or guarantee is received as a condition for restructuring a credit, to thoroughly evaluate it prior to acceptance (Paragraph 3.4.4).</li> </ul> <p>Appendix 2.1 of Completion Instructions of Banking Return Form MA(BS)2A provides guidelines on overdue and rescheduled assets. It provides guidance on factors (e.g., period of overdue, ways to determine loan expiry date) that need to be taken into account when determining whether an asset is overdue. It also provides guidance on when a problem asset could be reclassified as performing (e.g., a borrower has serviced all principal and interest payments on the asset in accordance with the revised repayment terms continuously for a reasonable period, and that there is reasonable assurance that the borrowers will continue to be able to service all future principal and interest payments). Under this framework, AIs are required to identify and report problem assets which may fall within one or more of the following categories:</p> <ul style="list-style-type: none"> <li>• classified assets: referring to assets graded as "Substandard", "Doubtful" or "Loss" in the HKMA's loan classification framework based on a set of qualitative and quantitative factors (see Paragraph 3 of the Completion Instructions for Banking Return Form MA(BS)2A Appendix 2 "Guideline on loan classification system", issued in December 2007).</li> <li>• overdue assets: generally referring to loans (in the case of loans with a specific expiry date) where the principal or interest is overdue and remains unpaid as at the reporting date, or (in the case of loans repayable on demand) where a demand for repayment has been served on the borrower but repayment has not been made in accordance with the instruction or (in the case of loans</li> </ul>

	<p>repayable by regular installments), where an installment payment is overdue and remains unpaid as at the reporting date (see Completion Instructions for Banking Return Form MA(BS)2A Appendix 2.1 "Guideline on Overdue and Rescheduled Assets", issued in December 2007, as well as Banking Return Form MA(BS)2A Note (3)).</p> <ul style="list-style-type: none"> <li>rescheduled assets: assets that have been restructured and renegotiated between the AI and the borrower because of deterioration in the financial position of the borrower or of the inability of the borrower to meet the original repayment schedule. These include loans for which the revised repayment terms, either of interest or of loan repayment period, are "non-commercial" to the AI (see Completion Instructions for Banking Return Form MA(BS)2A Appendix 2.1 "Guideline on Overdue and Rescheduled Assets", as well as Banking Return Form MA(BS)2A Note (3)).</li> </ul> <p>According to HKAS 39 Paragraph 59, a financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a "loss event) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.</p> <p>The BSD assesses whether AIs' classification of assets and provisioning are adequate through the supervisory processes / tools described in EC 2.</p>
<b>EC10</b>	<p>The supervisor determines that the bank's Board obtains timely and appropriate information on the condition of the bank's asset portfolio, including classification of assets, the level of provisions and reserves and major problem assets. The information includes, at a minimum, summary results of the latest asset review process, comparative trends in the overall quality of problem assets, and measurements of existing or anticipated deterioration in asset quality and losses expected to be incurred.</p>
<b>Description and findings re EC10</b>	<p>SPM CR-G-3 "Credit Administration, Measurement and Monitoring" Paragraph 3.1.6 recommends periodic review and monitoring of asset quality and adequacy of provisions at portfolio level by Credit Committee / Board of Directors. SPM CR-G-3 also specifies that AIs should have documented systems, procedures and processes for monitoring regularly the performance, quality and condition of individual credits and of the overall portfolio (Paragraph 3.1.2). The credit monitoring process is carried out at different levels (Paragraph 3.1.1). AIs should establish monitoring systems appropriate to their organization structures and the volume and complexity of their credit activities (Paragraph 3.1.6).</p> <p>SPM CR-G-3 Paragraph 3.2.1 specifies that AIs' management information should be capable of quantifying periodically and efficiently the credit risk of individual customers as well as that of the overall portfolio. The systems should be versatile and flexible enough to aggregate information in various meaningful ways in order to facilitate different types of analysis and to highlight risk concentrations.</p> <p>SPM CR-G-3 Paragraph 3.2.2 specifies that senior management of an AI should be</p>

	<p>provided with up-to-date management information to enable them to direct an AI's credit activities and control the associated risks. The information would normally cover, inter alia, the following:</p> <ul style="list-style-type: none"> <li>• total portfolio by internal credit rating and trend;</li> <li>• asset-based lending with loan-to-value ratios exceeding pre-set limits;</li> <li>• overdue accounts with ageing analysis;</li> <li>• credit downgrades and loans rescheduled during the period;</li> <li>• interest suspended;</li> <li>• adequacy of provisions;</li> <li>• undrawn commitment ratio; and</li> <li>• results of stress-tests.</li> </ul> <p>SPM CR-G-3 Paragraph 3.2.6 further specifies that based on periodic reports to the Board of Directors and senior management on the AI's credit portfolio, the AI should re-appraise its credit strategy and make appropriate adjustment as necessary.</p> <p>SPM IC-1 Paragraph 4.2.2 provides that an effective risk management information system should produce timely, accurate and reliable reports for the Board, senior management and line managers to support decision making at the different levels, and to enable early identification of emerging risks.</p> <p>The BSD determines adequacy of information submitted to the Board mainly through off-site monitoring and on-site examinations. The BSD in general obtains a list of the relevant AI's Management Information System reports (including the reports on asset quality classification and provisioning) submitted to the Board and top management, and where necessary, obtains samples of such reports for review. This is to ensure, among other things, that the information is appropriate for the purpose of understanding the condition of the AI's asset portfolio (including classification of assets, level of provisions and reserves and major problem assets) and is provided on a timely basis to the Board and other committees for review and action.</p> <p>The HKMA holds annual meeting with the Boards, the Board-level Audit Committees and / or Risk Committees of locally incorporated banks as appropriate. Among other things, this is to ensure that adequate corporate governance including the Boards' oversight of the banks' asset portfolios, classification of credits and level of provisioning is in place.</p> <p>On-site examination of AIs generally includes a review of the oversight exercised by the management and the Board / Credit Committee (including availability of management information to Board / Credit Committee and senior management and adequacy of their follow-up actions) on the AI's loan classification practice and provision adequacy.</p>
<b>EC11</b>	The supervisor requires that valuation, classification and provisioning, at least for significant exposures, are conducted on an individual item basis. For this purpose, supervisors require banks to set an appropriate threshold for the purpose of identifying significant exposures and to regularly review the level of the threshold.
<b>Description and</b>	Consistent with the provisions of HKAS 39, which is equivalent to International

<p><b>findings re EC11</b></p>	<p>Financial Reporting Standard 39, the following provisions are contained in SPM modules:</p> <p><i>SPM CR-G-1 "General Principles of Credit Risk Management"</i> Paragraph 5.4.2 provides that provisions should ideally be assessed on a loan-by-loan basis, with full provision being made for the likely loss. No specific threshold is prescribed, reflective of the variations in size and operations of AIs to which the guidance applies and the risk-based approach to supervision that the HKMA seeks to pursue.</p> <p><i>SPM CR-G-2 "Credit Approval, Review and Records"</i> Paragraph 3.1.1 requires each AI to have a system to ensure that, in addition to the on-going monitoring of the performance of credits, periodic credit reviews, of individual accounts or accounts managed on a portfolio basis (e.g., credit cards), are also carried out independently by the middle office, among other things, to:</p> <ul style="list-style-type: none"> <li>- ascertain changes in the credit quality of individual customers or other counterparties as well as the overall portfolio and detect unusual developments;</li> <li>- review whether changes to the classification of loans are necessary and provisions are adequate.</li> </ul> <p>Paragraph 3.1.3 requires AIs, as a general rule, to review all facilities, except those managed on a portfolio basis, individually at least on a yearly basis. Where facilities are irregular, larger or more risky, more frequent reviews would be necessary.</p> <p>In line with SPM CR-G-2 Paragraph 3.1.3, the HKMA generally requires AIs to perform regular assessment of the valuation, classification and provisioning of loans (not just the large credits) on an individual item basis (except for some forms of portfolio lending such as credit card or retail residential mortgage lending). The BSD determines whether AIs meet such requirement mainly through external auditors' review and on-site examinations.</p> <p>As mentioned in EC 2, the external auditors' review generally covers, among other things, the procedures for reviewing and setting aside individual impairment allowances and collective impairment allowances on a regular basis. To do so, AIs have established policies setting out the criteria (including setting of thresholds for different asset classes where appropriate) based on which the allowances would be assessed on a collective basis or individually. It is the general practice of external auditors to review whether the criteria and thresholds are set consistently and prudently.</p> <p>Also, as set out in SPM IC-3 Annex C, external auditors should have regard to the following in developing the audit procedures:</p> <ul style="list-style-type: none"> <li>(i) adequate provisions should be maintained;</li> <li>(ii) in general, these will be determined on a loan-by-loan basis, with full provision made for likely loss;</li> <li>(iii) in case of loans managed on a portfolio basis or where an AI is unable to determine the likely loss reliability on a loan-by-loan basis, minimum levels of</li> </ul>
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	<p>provision may be set for each loan grade under the HKMA's loan classification system.</p> <p>When reviewing AIs' valuation, classification and provisioning policies during on-site examinations, the BSD assesses the appropriateness of the criteria set by AIs for determining the types of exposures that should be subject to valuation, classification and provisioning on an individual items basis.</p>
<b>EC12</b>	<p>The supervisor regularly assesses any trends and concentrations in risk and risk build-up across the banking sector in relation to banks' problem assets and takes into account any observed concentration in the risk mitigation strategies adopted by banks and the potential effect on the efficacy of the mitigant in reducing loss. The supervisor considers the adequacy of provisions and reserves at the bank and banking system level in the light of this assessment.</p>
<b>Description and findings re EC12</b>	<p>SPM SA-1 "Risk-based Supervisory Approach" aims, inter alia, at putting greater emphasis on early identification of emerging risks at individual AIs and on a sector-wide basis. The methodology is designed to establish a forward-looking view on the risk profile of AIs and focus on the areas of greatest risk to an AI. It also enables the HKMA to be proactive with a view to pre-empting any serious threat to the stability of the banking system from any current or emerging risks.</p> <p>The HKMA adopts a forward-looking supervisory approach to proactively identify and address the risks arising from business activities of the banking sector. These include an array of conventional tools for micro-supervision (e.g., on-site examinations, off-site surveillance and stress testing) and macro-prudential surveillance in order to identify evolving risks that might have important impact on the operations and risk profiles of individual banking institutions as well as the banking system as a whole.</p> <p>The BSD monitors market developments through a number of means, including collection and analysis of data on the amount and quality of loans, debt securities and off-balance sheet exposures in derivatives and securitization transactions of AIs through banking returns and surveys on a regular or ad-hoc basis, contacts with market participants and fellow regulators, and review of related news and publications. Through these processes, the BSD assesses the trends and concentrations in risk and risk build-up across the banking sector. Where there are significant risk concentrations being built up, the BSD will review the risk mitigation strategies adopted by banks.</p> <p>Although the level of problem loans in Hong Kong has been low in the past few years (e.g., classified loan ratio of retail banks was 0.46 percent at end of Q1 2013), the BSD noted that the banking sector was exposed to two major types of concentrated risks, namely residential mortgage lending and non-bank Mainland China exposures (NBMCE). The following supervisory actions were taken to contain the build-up of the identified risks:</p> <p>(i) <i>Residential mortgage lending</i></p> <p>Property related lending constitutes a significant portion of AIs' lending portfolios. The HKMA has been closely monitoring property prices in general and the loan-to-value (LTV) ratios of property related loans granted by individual AIs. In light of continuous</p>



	<p>increases in property prices in recent years, the HKMA introduced a series of countercyclical macroprudential measures (e.g., lowering the cap on LTV ratio) to guard against the potential impacts of the risk of a property bubble on banking stability.</p> <p>(ii) <i>Non-bank Mainland China exposures</i></p> <p>In view of the rapid increase in Mainland-related trade financing activities in recent years and the high growth rates recorded particularly in 2013, the BSD requested the internal audit functions of relevant AIs to conduct a thematic review of these activities with a view to, inter alia, guarding against building up problem assets.</p> <p>With the increasing Mainland-related business conducted by AIs, the BSD stepped up surveillance of these activities and requested AIs concerned to report more granular information on their non-bank Mainland China exposures with a view to early identification of emerging risks of problem assets as well as concentration in risk mitigation.</p> <p>The BSD conducts thematic on-site examinations on AIs active in Mainland-related business on a regular basis. In view of the results of its analysis of the risk mitigation position of NBMCE, one of the key areas included in the scope of the thematic on-site examinations on NBMCE in 2013 was collateral and guarantee management, including the AI's system to locate concentration risk on collateral types.</p>
<b>Assessment of Principle 18</b>	Compliant.
<b>Comments</b>	Through the use of reports submitted on a regular basis, the review of external auditor reports and on-site examinations, the HKMA closely monitors problem assets at individual AIs. Supervisory staff evaluates the adequacy of banks' classification and provisioning policies for both on- and off-balance sheet exposures. Very importantly, the HKMA has addressed the conceptual difference between the accounting (incurred loss) and supervisory approaches to provisioning by requiring Hong Kong banks to maintain a "regulatory reserve" to help neutralize the effect of accounting changes implemented in 2005. This has helped to ensure that banks maintain adequate loan loss provisions.
<b>Principle 19</b>	Concentration risk and large exposure limits. The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties. <sup>56</sup>
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require banks to have policies and processes that provide a comprehensive bank-wide view of significant sources of concentration risk. <sup>57</sup>

<sup>56</sup> Connected counterparties may include natural persons as well as a group of companies related financially or by common ownership, management or any combination thereof.

<sup>57</sup> This includes credit concentrations through exposure to: single counterparties and groups of connected counterparties both direct and indirect (such as through exposure to collateral or to credit protection provided by a single counterparty), counterparties

(continued)

	Exposures arising from off-balance sheet as well as on-balance sheet items and from contingent liabilities are captured.
<b>Description and findings re EC1</b>	<p>BO Part XV contains various statutory limitations to regulate concentration risks of AIs, including:</p> <ul style="list-style-type: none"> <li>• BO section 81 provides that a locally incorporated AI shall not incur financial exposure to any one person or to two or more companies which are subsidiaries of the same holding company or have the same controller (not being a company) or to any holding company and one or more of its subsidiaries or to any one person (not being a company) and one or more companies of which that person is a controller, in excess of 25 percent of the AI's capital base. Financial exposure is defined under BO section 81(2) and covers both on-balance sheet items and off-balance sheet items, such as loan commitments and guarantees.</li> <li>• BO section 87(1) provides that a locally incorporated AI shall not acquire or hold any part of the share capital of any other company or companies to an aggregate value in excess of 25 percent of the AI's capital base.</li> <li>• BO section 88(1) provides that a locally incorporated AI shall not purchase or hold any interests in land situated in or outside Hong Kong of a value or to an aggregate value in excess of 25 percent of the AI's capital base.</li> <li>• BO section 83 states that any facility provided by a locally incorporated AI to a person specified in BO section 83(4) shall not exceed in aggregate 10 percent of the capital base of the AI. See responses to Principle 20 for details.</li> <li>• BO section 90(1) sets an overall limitation on the aggregate facilities and holdings under BO sections 83, 87 and 88 to the amount of 80 percent of the capital base of the AI.</li> </ul> <p>Under BO section 79A, the MA may, by notice in writing to an AI, require the provisions in the BO Part XV to apply to the AI on a consolidated basis or on both a consolidated basis and an unconsolidated basis. The relevant guidance is set out in SPM CR-L-1 "Consolidated Supervision of Concentration Risks under Part XV: BO §79A."</p> <p>The above regulatory framework is complemented by SPM CR-G-8 "Large Exposures and Risk Concentrations" which requires AIs to maintain adequate policies, systems and processes to manage and control their large exposures and risk concentrations in addition to complying with the Part XV limitations.</p> <p>For the purposes of SPM CR-G-8, the scope of risk concentrations that an AI should manage or guard against includes those arising from exposures to (i) individual counterparties or groups of related counterparties; (ii) particular types of asset (e.g., land, shares or securities); (iii) counterparties in the same industry, geographical location, or economic sector; (iv) types of lending with similar characteristics (e.g.,</p>

in the same industry, economic sector or geographic region and counterparties whose financial performance is dependent on the same activity or commodity as well as off-balance sheet exposures (including guarantees and other commitments) and also market and other risk concentrations where a bank is overly exposed to particular asset classes, products, collateral, or currencies.

	<p>property lending, share margin financing, taxi loans, etc.); and (v) industries or countries that have a close economic linkage (e.g., they may be affected through contagion). AIs should also avoid undue reliance on collateral or guarantees and ensure other risks (i.e. other than credit risk) associated with large exposures (e.g., legal, operational and market risks) are adequately monitored and controlled.</p> <p>The Board of a locally incorporated AI should ensure that the AI establishes a policy on the control of large exposures and risk concentrations and associated procedures and systems to ensure compliance with the policy. The policy should cover the following:</p> <ul style="list-style-type: none"> <li>• the definition of exposure, taking into account the nature of the AI's business and complexity of its products. Exposures to a counterparty should include its on- and off-balance sheet exposures and indirect exposures. Exposures arising from securities, foreign exchange, derivatives etc. should also be captured. SPM CR-G-13 section 4.4 sets out the methodologies and systems that AIs should adopt in measuring the counterparty credit risk of such exposures.</li> <li>• individual and aggregate exposure limits for various types of counterparty (e.g., governments, banks, corporate and individual borrowers);</li> <li>• aggregate maximum exposure limits for an industry, an economic sector, a country, a region or a group of borrowers which have a similar or homogeneous risk;</li> <li>• the delegation of credit authority for approving large exposures, and the circumstances for approving excesses over internal exposure limits;</li> <li>• the procedures for identifying, reviewing, monitoring and controlling large exposures; and</li> <li>• the responsibility for reporting large exposures to the HKMA and for ensuring compliance with the Part XV limitations.</li> </ul> <p>The policy on large exposures and risk concentrations should be agreed with the HKMA, and any changes to the policy need prior consultation with the HKMA.</p> <p>See responses to EC 3 for details of the internal limits AIs are required to set to control large exposures and risk concentrations.</p> <p>SPM CR-G-8 Paragraphs 5.4.1 and 5.4.2 specify that AIs should maintain regular and independent checks on the adequacy of controls over large exposures and on compliance with relevant internal policies and applicable laws and regulatory requirements, and ensure that their internal or external auditors conduct a regular review of the quality of large exposures and controls to safeguard against risk concentrations.</p> <p>The BSD ensures that locally incorporated AIs maintain adequate policies, systems and processes to manage their large exposures and risk concentrations through the following supervisory processes and tools:</p> <p><i>Review of AI's large exposures and risk concentrations policies</i></p> <p>AIs are required to establish policies for the control of large exposures and risk concentrations. Risk concentrations can take many forms, including exposure to</p>
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	<p>particular types of assets (e.g., interest in land or shares), individual counterparties, groups of related counterparties, and counterparties in specific geographical locations, economic or industry sectors. The BSD reviews the policies submitted by AIs and, if necessary, requires them to make enhancements to the policies.</p> <p><i>Review of statutory returns submitted by AIs</i></p> <p>AIs are required under BO sections 63(1) and 63(2), to submit the following banking returns, among others, on a quarterly basis:</p> <ol style="list-style-type: none"> <li>i. Return of Large Exposures (MA(BS)1D) captures information on AIs' large bank and non-bank exposures (e.g., those equal to or exceeding 10 percent of capital base). Both on-balance sheet and off-balance exposures are required to be reported in the return.</li> <li>ii. Certificate of Compliance with the BO, in which AIs are required to certify their compliance with certain sections of the BO, including those that are related to large exposures and risk concentration; and</li> <li>iii. Analysis of Loans and Advances and Provisions captures information on an AI's loans and advances by economic sector.</li> </ol> <p>The BSD reviews the above returns to monitor AIs' large exposures and risk concentrations and their compliance with the relevant statutory and regulatory limits.</p> <p><i>Review of external auditors' reports</i></p> <p>The MA generally requires individual AIs to submit external auditors' reports annually under BO sections 63(3) and 63(3A). These cover, for example, whether the Return of Large Exposures and other relevant reports have been compiled correctly.</p> <p>The BSD reviews the external auditors' reports to ascertain whether any deficiency is identified in the relevant internal controls, and if so, requires the AIs to take timely actions to address the issue.</p> <p><i>Off-site review of information from AIs</i></p> <p>It is a general practice of the BSD to obtain and review selected Board and Committee meeting minutes and internal risk management reports of AIs to monitor the key risks of the AIs as well as understand the timeliness and quality of information and reports submitted to AIs' Board and senior management.</p> <p>As these minutes and reports usually contain information about the AIs' large exposures and risk concentrations, the BSD makes use of them to assess:</p> <ul style="list-style-type: none"> <li>• the involvement of AIs' Board/Committee and senior management in the monitoring and managing of large exposures and risk concentrations; and</li> <li>• the compliance with the relevant statutory, regulatory and internal limits by the AIs.</li> </ul> <p>In addition, the BSD may also obtain and review AIs' internal auditors' reports on large exposures and risk concentrations.</p>
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	<p><i>On-site examinations</i></p> <p>Taking a risk-focused approach, the BSD considers the need to examine individual AIs' management of risk concentrations and large exposures including the counterparty credit risk exposures, taking into account the risk profile of AIs and other relevant information collected during its ongoing supervision.</p> <p>If necessary, the scope of the on-site examination may cover the adequacy and effectiveness of AIs' risk management policies, procedures and systems for:</p> <ul style="list-style-type: none"> <li>• identifying, measuring, monitoring, managing and reporting concentration risk and large exposures including counterparty credit risk exposures, and</li> <li>• ensuring compliance with relevant statutory and regulatory requirements.</li> </ul>
<b>EC2</b>	The supervisor determines that a bank's information systems identify and aggregate on a timely basis, and facilitate active management of, exposures creating risk concentrations and large exposure <sup>58</sup> to single counterparties or groups of connected counterparties.
<b>Description and findings re EC2</b>	<p>Relevant guidance is included in SPM CR-G-8 "Large Exposures and Risk Concentrations", which specifies that:</p> <ul style="list-style-type: none"> <li>• the Board of an AI should ensure that the AI establishes a policy on the control of large exposures and risk concentrations that covers the identification, measurement and control of such exposures and the criteria for identifying a group of related persons;</li> <li>• AIs should have a central liability record for each large exposure that should enable them to monitor such exposures against the statutory or internal limits on a daily basis;</li> <li>• every AI should have adequate management information and reporting systems that enable management to identify risk concentrations within the asset portfolio of the AI or of the group (including subsidiaries and overseas branches) on a timely basis;</li> <li>• where applicable, internal limits for controlling risk concentrations should be monitored on both a solo and a consolidated basis;</li> <li>• AIs should maintain regular and independent checks on the adequacy of controls over large exposures and on compliance with relevant internal policies and applicable laws and regulatory requirements; and</li> <li>• the Board should ensure that large exposures are approved by the appropriate level of management of the AI.</li> </ul> <p>Exposures to a counterparty should include its on- and off-balance sheet exposures,</p>

<sup>58</sup> The measure of credit exposure, in the context of large exposures to single counterparties and groups of connected counterparties, should reflect the maximum possible loss from their failure (i.e. it should encompass actual claims and potential claims as well as contingent liabilities). The risk weighting concept adopted in the Basel capital standards should not be used in measuring credit exposure for this purpose as the relevant risk weights were devised as a measure of credit risk on a basket basis and their use for measuring credit concentrations could significantly underestimate potential losses (see "Measuring and controlling large credit exposures, January 1991).

	<p>including commitments and guarantees as well as exposures arising from securities, foreign exchange, derivatives etc.</p> <p>The BSD determines whether an AI's information systems identify and aggregate on a timely basis, and facilitate active management of, exposures creating risk concentrations and large exposures through the supervisory processes and tools mentioned in EC 1.</p> <p>When reviewing an AI's large exposures and concentration policy, the BSD assesses the effectiveness of the AI's policies and procedures for identifying, reviewing, monitoring and controlling large exposures.</p> <p>The BSD may, where necessary, include in the scope of its on-site examinations the adequacy and effectiveness of AIs' management information systems for identification and aggregation of risk exposures and for providing timely information to facilitate AIs' active management of large exposures and risk concentrations.</p> <p>According to SPM IC-3 "Reporting Requirements Relating to Authorized Institutions' External Auditors under the BO" Annex B, the auditors' procedures for reviewing an AI's internal controls for ensuring compliance with BO sections 81 and 83 generally cover the following:</p> <ul style="list-style-type: none"> <li>(i) whether an AI's internal reporting and monitoring systems are able to provide timely information for management's attention or action;</li> <li>(ii) whether a central liability record to ensure compliance with BO sections 81 and 83 is maintained by the AI to capture all financial exposures to relevant customers and that record is kept up-to-date at all times; and</li> <li>(iii) whether limits are established for customers or groups of related customers to prevent any potential breach of the BO.</li> </ul> <p>If the BSD identifies any inadequacy surrounding an AI's management information systems for managing large exposures and risk concentration, it takes necessary actions to ensure timely rectification of such issues by the AI.</p>
<b>EC3</b>	<p>The supervisor determines that a bank's risk management policies and processes establish thresholds for acceptable concentrations of risk, reflecting the bank's risk appetite, risk profile and capital strength, which are understood by, and regularly communicated to, relevant staff. The supervisor also determines that the bank's policies and processes require all material concentrations to be regularly reviewed and reported to the bank's Board.</p>
<b>Description and findings re EC3</b>	<p>Under SPM CR-G-8 "Large Exposures and Risk Concentrations" section 5, the Board should ensure that the AI establishes a policy on the control of large exposures and risk concentrations. The AI is required to agree its policy with the MA. The policy should include internal limits for controlling large exposures and risk concentrations, including:</p> <ul style="list-style-type: none"> <li>• exposures arising from securities, foreign exchange, derivatives or other off-balance sheet exposures not specified in BO section 81(3);</li> </ul>

	<ul style="list-style-type: none"> <li>• individual and aggregate exposure for various types of counterparty;</li> <li>• aggregate maximum exposure for an industry, an economic sector, a country, a region or a group of borrowers which have a similar or homogeneous risk; and</li> <li>• aggregate non-exempt large exposures (clustering limit).</li> </ul> <p>AIs' internal limits should be reasonable in relation to their capital base and balance sheet size.</p> <p>Moreover, the Board of an AI should receive regular reports to facilitate its review of the AI's large exposures and risk concentrations. If a concentration exists, an AI is expected to reduce it in accordance with its prescribed policies.</p> <p>The HKMA determines whether the relevant risk management policies, processes, and oversight of AIs are in place mainly through the supervisory processes and tools mentioned in EC 1.</p> <p>When reviewing AIs' large exposures and risk concentration policies, the BSD assesses:</p> <ul style="list-style-type: none"> <li>• the adequacy and appropriateness of the thresholds and limits set by the AIs; and</li> <li>• the adequacy of the procedures for identifying, reviewing, monitoring and controlling large exposures.</li> </ul> <p>In addition, the risk appetite statements, Board/Committee meeting minutes and internal risk management reports collected from AIs usually contain information about AIs' risk appetite of, and internal limits on, risk concentrations. In reviewing these documents, the BSD considers the appropriateness of the relevant thresholds and limits established by the AIs and the adequacy of information provided to the Board and senior management.</p> <p>The BSD may, where necessary, conduct an on-site examination to assess:</p> <ol style="list-style-type: none"> <li>(i) the appropriateness of the limits and thresholds set by an AI for management of large exposures and risk concentrations;</li> <li>(ii) whether such limits and thresholds are properly approved by Board/Committee or senior management, and communicated to relevant staff, and;</li> <li>(iii) the adequacy and effectiveness of the systems and processes for monitoring large exposures and risk concentrations and reporting them to the Board/Committee and senior management.</li> </ol>
<b>EC4</b>	The supervisor regularly obtains information that enables concentrations within a bank's portfolio, including sectoral, geographical and currency exposures, to be reviewed.
<b>Description and findings re EC4</b>	Under BO section 63(2), the MA may require an AI to submit such information as he may reasonably require for the exercise of his functions under the BO. Existing banking returns collected under this BO power that serve the purposes of monitoring concentration risks of an AI include:

- Foreign Currency Position of an Authorized Institution (MA(BS)6) which collects information on the amount of net long (short) position in each currency and gold;
- Quarterly Analysis of Loans and Advances and Provisions (MA(BS)2A) which includes breakdown of an AI's loan portfolio into different industries and economic sectors;
- Large Exposures (MA(BS)1D) which requires an AI to report its ten largest exposures and all exposures exceeding 10 percent of its capital base during a quarter;
- Certificate of Compliance with the BO of an AI incorporated in Hong Kong and Certificate of Compliance with the BO of an AI incorporated outside Hong Kong, which require an AI to certify its compliance with various statutory limits under the BO; and
- Return of External Positions – Hong Kong Office(s) Position (MA(BS)9A) and Consolidated Position of Cross Border Claims (MA(BS)9B) which collects information on an AI's exposure to each country.

The MA may require an AI to submit to him a report prepared by an auditor as to whether, in the auditor's opinion, the returns submitted by the AI to the MA are correctly compiled from the books and records of the AI. The MA may also require an AI to submit a report prepared by the AI's external auditors as to whether, in the opinion of auditor, the AI has in place systems of control that were adequate to enable the AI's returns and information (including Banking Return Form MA(BS)1D) to be correctly compiled and to enable the AI to comply with various statutory duties which include the limitation on large exposures.

Pursuant to the BO Schedule 7 Paragraph 12, the HKMA may set prudential limits to prevent AIs from taking excessive concentration risks that may be detrimental to the interests of depositors or potential depositors.

If an AI is, in the opinion of the MA, exposed to a significant level of risk concentration that may affect its financial stability, the HKMA may set prudential limits on the AI's exposure to particular counterparties, groups of counterparties, economic or geographical sectors. The HKMA may also direct an AI to take other necessary measures to reduce its level of risk concentration.

Regarding the concentration of foreign exchange risk, in the case of locally incorporated AIs, the HKMA may ask an AI to reduce its aggregate open position limit or strengthen its capital position if AIs have relatively large aggregate open position limits (say, higher than 25 percent of their capital base). For branches of AIs incorporated outside Hong Kong, it is the responsibility of their overseas head offices and home supervisory authorities to monitor their foreign exchange positions limits centrally. However, the HKMA will assess the expertise of any branch that has an aggregate overnight limit that appears large, say, in excess of 5 percent of the AI's capital base as a whole.

Credit concentration risk of an AI is one of the factors considered by the MA in determining the minimum capital requirement of the AI under the Supervisory Review



	<p>Process (SRP). Scoring worksheets to facilitate assessment are used in the SRP.</p> <p>The BSD reviews AIs' risk concentrations in terms of exposures to various economic sectors, countries and individual counterparties or group of related counterparties through the following means:</p> <p><i>Review of banking returns and surveys</i> On a monthly or quarterly basis, the BSD reviews various statutory returns submitted by AIs. The information contained in the returns is analyzed at different levels, e.g., individual AIs, peer groups and the banking sector as a whole. Moreover, the BSD collects and reviews other regular surveys, e.g., survey on credit card receivables, residential mortgage lending, taxi financing, Mainland-related business activities, etc., to monitor AIs' exposures to certain sectors and the underlying risks.</p> <p>The review of the above returns and surveys by the BSD provides it an understanding of AIs' distributions of assets in various sectors, countries and individual counterparties or groups of counterparties so as to note for any risk concentrations that may suggest potential systematic risks to the banking sector or inherent risks to individual AIs.</p> <p><i>Review of internal risk management reports submitted by AIs</i> It has been a general practice of the BSD to obtain AIs' Board / Committee meeting minutes and internal risk management reports to review the AIs' risk exposure levels or ascertain whether limits are adhered to.</p> <p><i>Review of financial disclosures</i> The BSD would review AIs' financial disclosure statements and/or annual reports, which may contain additional information about their risk concentrations.</p>
<b>EC5</b>	<p>In respect of credit exposure to single counterparties or groups of connected counterparties, laws or regulations explicitly define, or the supervisor has the power to define, a "group of connected counterparties" to reflect actual risk exposure. The supervisor may exercise discretion in applying this definition on a case by case basis.</p>
<b>Description and findings re EC5</b>	<p>Under BO section 81(1), a locally incorporated AI is subject to a statutory limit of 25 percent of its capital base in respect of its financial exposure to any one person or group of related persons. Due to the exclusion of certain exposures provided in BO section 81(6), it can be said that the statutory limit mainly relates to exposures to private sector non-bank borrowers and counterparties. For the purposes of applying this limit, a group of related persons (the exposure to which is treated as a single exposure) comprises any one of the following groupings specified in BO section 81(1):</p> <ul style="list-style-type: none"> <li>• two or more companies which are subsidiaries of the same holding company;</li> <li>• two or more companies which have the same controller (not being a company);</li> <li>• any holding company and one or more of its subsidiaries; and</li> <li>• any one person (not being a company) and one or more companies of which that person is a controller.</li> </ul> <p>Where the exposure of an AI is to a subsidiary or holding company of an AI or a subsidiary of such holding company, the MA may specify, by notice in writing, and</p>

	<p>subject to such conditions as he may consider appropriate, that the AI's exposure to that person shall not apply for the purpose of determining the AI's financial exposure. The MA may also so specify where the exposure is to subsidiaries of a holding company which is an AI or a holding company of an AI or where the exposure is to a holding company and one of its subsidiaries, where the holding company is a holding company of an AI.</p> <p>As indicated in SPM CR-G-8 "Large Exposures and Risk Concentrations" Paragraph 3.8, the group of persons specified in BO section 81(1) is the minimum standard used for the purpose of calculating the financial exposure limit. AIs should adopt a more prudent approach for concentration risk management purposes. Ideally, the group of counterparties used for concentration risk management purposes should capture all parties connected in such a way that the financial strength of any of them may affect that of the others, e.g., counterparties linked by cross-guarantees or whose liabilities are guaranteed by the same guarantor.</p> <p>The HKMA may specify the definition of group of related counterparties for regulatory reporting. In the Completion Instructions for the Return of Large Exposures, "group of related counterparties" is defined as "parties which are connected in such a way that the financial soundness of any of them may affect the financial soundness of the others."</p> <p>According to SPM CR-G-8 Paragraphs 5.2.2 and 5.2.4, AIs' large exposures and risk concentration policies should cover, among others, the criteria to be used for identifying a group of related persons. The BSD will review the criteria and, if necessary, require AIs to amend them.</p>
<b>EC6</b>	<p>Laws, regulations or the supervisor set prudent and appropriate<sup>59</sup> requirements to control and constrain large credit exposures to a single counterparty or a group of connected counterparties. "Exposures" for this purpose include all claims and transactions (including those giving rise to counterparty credit risk exposure), on-balance sheet as well as off-balance sheet. The supervisor determines that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis.</p>
<b>Description and findings re EC6</b>	<p>BO section 81 provides that an AI incorporated in Hong Kong must not incur financial exposure to any one person or company or combination as referred to BO section 81(1) that exceeds an amount equivalent to 25 percent of the capital base of the AI. Under BO section 79A, the MA may by notice to an AI that has any subsidiary, require that this limit apply to the AI on a solo or consolidated basis or both. There are various statutory exemptions in relation, for example, to financial exposures to other banks and AIs, and central banks or governments of Tier 1 countries.<sup>60</sup></p>

<sup>59</sup> Such requirements should, at least for internationally active banks, reflect the applicable Basel standards. As of September 2012, a new Basel standard on large exposures is still under consideration.

<sup>60</sup> A Tier 1 country is defined in the BO as a country which is a member of the Organization for Economic Co-operation and Development or a country which has concluded a special lending arrangement with the IMF associated with the Fund's General

(continued)

	<p>BO section 81(2) specifically provides that financial exposures to which BO section 81(1) applies include an AI's on- and off-balance sheet exposures.</p> <p>The holding of interests by locally incorporated AIs in land (excluding bank premises) situated in or outside Hong Kong or in share capital of any other companies is limited to an aggregate of 25 percent of their capital base in each case.</p> <p>Apart from the statutory requirements, SPM CR-G-8 "Large Exposures and Risk Concentrations" Paragraph 4.2.2 and section 5.2 require an AI to have internal limits for controlling non-exempt large exposures and risk concentrations. These include limits on:</p> <ul style="list-style-type: none"> <li>• exposures to particular counterparties, groups of counterparties, economic or geographic sectors;</li> <li>• aggregate non-exempt large exposures<sup>61</sup> which should be controlled by a "clustering limit"; and</li> <li>• exposures arising from securities, foreign exchange, derivatives or other off-balance sheet items not covered under section 81(3).</li> </ul> <p>Such internal limits should be set on both a solo basis and a consolidated basis where applicable.</p> <p>SPM CR-G-8 section 4 further states that the HKMA may set prudential limits to prevent AIs from taking excessive concentration risks.</p> <p>Under SPM CR-G-13 "Counterparty Credit Risk Management" Paragraph 4.6.2, counterparty credit risk exposures should be managed at the counterparty level (i.e. aggregating with other credit exposures to a given counterparty), across business lines and on a consolidated basis to cover the aggregate credit exposures to the counterparty. SPM CR-G-13 also requires AIs' counterparty credit risk measurement systems to capture both on-and off-balance sheet exposures and to enable the identification of large or concentrated positions, such as by groups of related counterparties, market/industry sectors or underlying market risk factors (e.g., interest rates and exchange rates).</p> <p>The statutory criteria and prudential expectations apply to all locally incorporated AIs. For AIs incorporated outside Hong Kong, the overall supervision of large exposures is the responsibility of their home supervisors. Nevertheless, they are required under BO section 63(2) to report the ten largest exposures of their Hong Kong operations (Banking Return Form MA(BS)1D)) and certify compliance with relevant provisions under the BO in respect of limitations on exposures and risk concentrations applicable</p>
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Arrangements to Borrow, and also includes Hong Kong but excludes any country which has rescheduled its external sovereign debt, whether to central government or non-central government creditors, within the previous five years.

<sup>61</sup> These are exposures equal to or exceeding 10% of an AI's capital base but not currently exempted under BO section 81.

	<p>to them (Banking Return Form MA(BS)1F(b)).</p> <p>To ensure that the above criterion can be met by AIs, the MA expects their management to exercise adequate oversight of controls over large exposures and risk concentrations. (Please see also EC 1.)</p> <p>In addition to the statutory and regulatory requirements, the BSD may require AIs to observe additional requirements to control and constrain large credit exposures to a single counterparty or a group of related counterparties.</p> <p>For example, in some cases where certain local AIs that form part of international banking group have sustainable exposures to the rest of their banking group, the BSD has requested the local AIs concerned to reduce or limit the relevant exposures to or below an agreed level.</p> <p>The BSD determines whether the senior management monitors the relevant statutory and regulatory limits and whether such limits are complied with (on a solo basis and a consolidated basis).</p>
<b>EC7</b>	The supervisor requires banks to include the impact of significant risk concentrations into their stress testing programs for risk management purposes.
<b>Description and findings re EC7</b>	<p>Under SPM IC-5 "Stress-testing" section 2, AIs are required to develop and implement a forward-looking stress-testing program that entails an assessment of their risk exposures under stressed conditions and enables them to put in place appropriate risk-mitigating strategies (e.g., restructuring positions) and contingency plans across a range of stressed conditions. AIs are expected to draw up a list of major risk factors that should be tested under stress scenarios, with risk concentration considered a major risk factor that may be relevant to AIs.</p> <p>As set out in the aforementioned SPM, AIs are required to include significant risk concentrations in their stress testing programs for risk management purposes. It is a general practice of the BSD to review, regularly or on a need basis, the stress-testing results of AIs. Where necessary, BSD will discuss the results of, or any deficiencies identified in, the stress testing program with the AIs.</p> <p>The BSD monitors the progress of AIs' implementation of the relevant requirements during its on-going supervisory contacts with the AIs. In addition, to gain understanding on the status of AIs in meeting the requirements in SPM IC-5, the BSD scheduled a round of thematic examinations on stress testing of selected AIs throughout 2013.</p>
<b>Additional criteria</b>	
<b>AC1</b>	<p>In respect of credit exposure to single counterparties or groups of connected counterparties, banks are required to adhere to the following:</p> <ul style="list-style-type: none"> <li>(a) ten per cent or more of a bank's capital is defined as a large exposure; and</li> <li>(b) twenty-five per cent of a bank's capital is the limit for an individual large</li> </ul>

	<p>exposure to a private sector non-bank counterparty or a group of connected counterparties.</p> <p>Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialized banks.</p>
<b>Description and findings re AC1</b>	<p>Though not specifically included in the BO, it is the MA's policy to follow the Basel recommendation in this Additional Criterion of defining a large exposure as one that is 10 percent or more of an AI's capital base. This definition is used in SPM CR-G-8 "Large Exposures and Risk Concentrations", where Paragraph 4.2.5 refers to aggregation of those exposures which are equal to or more than 10 percent of its capital base and not currently exempted from BO section 81. It is also used in the Return for Large Exposures for monitoring and reporting large exposures.</p> <p>BO section 81(1) provides that an AI incorporated in Hong Kong must not incur financial exposure to a person or a company or a combination as referred to in section 81(1) that exceeds an amount equivalent to 25 percent of its capital base.</p> <p>There is no allowance for exceeding the 25 percent statutory limit under BO section 81(1) (other than the MA's power under section 81(5) to apply a higher statutory limit in respect of an AI's financial exposures to a counterparty or counterparties who is or are trustee(s) on a case-by-case basis). Under BO section 81(9) every director, every chief executive and every manager of an AI who contravenes the requirements commits an offence and is liable to fines and imprisonment under the BO.</p> <p><i>Defining large exposures as 10 percent or more of a local AI's capital base</i> <i>Regulatory Reporting</i> Local AIs are required to report in the Return of Large Exposures all the bank exposures and non-bank exposures that are equal to or exceed 10 percent of the capital base.</p> <p><i>Clustering Limit</i> The BSD generally requires a local AI to set an internal limit to control the aggregate of its non-exempt large exposures, i.e. exposures that are equal to or more than 10 percent of its capital base and not currently exempted from BO section 81(1). The BSD will consider the appropriateness of the limits set by AIs.</p> <p><i>Statutory limit of 25 percent of a local AI's capital base under BO section 81(1)</i> If a locally incorporated AI contravenes BO section 81 with financial exposure to a person or a company or a combination, exceeding 25 percent of the AI's capital base, the HKMA will require the AI to rectify the contravention as soon as possible.</p> <p>In addition, the BSD will decide whether to refer the case to the Department of Justice (see Principle 11 EC 5).</p> <p><i>Monitoring large exposures and compliance with regulatory/ statutory limit</i> The BSD monitors AIs' compliance with the 25 percent statutory limit and other reporting requirements for large exposures.</p>

<b>Assessment of Principle 19</b>	Compliant.
<b>Comments</b>	The HKMA utilizes reports received from banks on a quarterly basis to monitor large exposures (defined as equal to or exceeding 10 percent of the bank's capital base) and risk concentrations. Through on-site examinations, supervisory staff determines that banks' management information systems identify and aggregate on a timely basis risk concentrations and that senior management and Boards of AIs utilize this information to actively oversee risk concentrations. In addition, banks are required to include significant risk concentrations in their stress testing programs for risk management purposes.
<b>Principle 20</b>	Transactions with related parties. In order to prevent abuses arising in transactions with related parties <sup>62</sup> and to address the risk of conflict of interest, the supervisor requires banks to enter into any transactions with related parties <sup>63</sup> on an arm's length basis; to monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes.
<b>Essential criteria</b>	
<b>EC1</b>	Laws or regulations provide, or the supervisor has the power to prescribe, a comprehensive definition of "related parties." This considers the parties identified in the footnote to the Principle. The supervisor may exercise discretion in applying this definition on a case by case basis.
<b>Description and findings re EC1</b>	BO section 83(1) prohibits a locally incorporated AI from providing unsecured loans, advances or guarantees or incurring unsecured liabilities to certain persons and bodies specified in BO section 83(4) if the aggregate amount of the facilities or liabilities exceeds 10 percent of the AI's capital base. The specified persons and bodies are: <ul style="list-style-type: none"> <li>(i) any director of the AI and any of his relatives (as defined under BO section 79(1));</li> <li>(ii) any employee of the AI who is responsible, either individually or as a member of a committee, for approving loan applications and any of his relatives;</li> <li>(iii) any controller (majority shareholder or indirect controller) or minority shareholder controller of the AI (other than an AI or a bank incorporated outside Hong Kong which is not an AI but is approved by the MA for the purpose of BO section 83(4)(e)) and (if the controller or minority shareholder controller is an individual) any of his relatives;</li> <li>(iv) any firm, partnership or non-listed company (other than a firm, partnership or non-listed company which is an AI, or a bank incorporated outside Hong Kong</li> </ul>

<sup>62</sup> Related parties can include, among other things, the bank's subsidiaries, affiliates, and any party (including their subsidiaries, affiliates and special purpose entities) that the bank exerts control over or that exerts control over the bank, the bank's major shareholders, Board members, senior management and key staff, their direct and related interests, and their close family members as well as corresponding persons in affiliated companies.

<sup>63</sup> Related party transactions include on-balance sheet and off-balance sheet credit exposures and claims, as well as, dealings such as service contracts, asset purchases and sales, construction contracts, lease agreements, derivative transactions, borrowings, and write-offs. The term transaction should be interpreted broadly to incorporate not only transactions that are entered into with related parties but also situations in which an unrelated party (with whom a bank has an existing exposure) subsequently becomes a related party.

	<p>which is not an AI but is approved by the MA for the purposes of BO section 83(4)(g)) in which the AI or any of its controllers, minority shareholder controllers or directors (or any of their relatives in the case of individuals) is interested as director, partner, manager or agent; and</p> <p>(v) any individual, firm, partnership or non-listed company of which any controller, minority shareholder controller or director of the AI (or any of their relatives in the case of individuals) is a guarantor.</p> <p>The term “relative” referred to above has the same meaning as defined in BO section 79(1).</p> <p>Under BO section 83(2), the maximum aggregate unsecured facilities granted to connected parties of a locally incorporated AI who are individuals specified in (i), (ii) and (iii) above shall not exceed HK\$1 million per person or 5 percent of the AI’s capital base. BO section 83(6) further provides that facilities granted to or on behalf of any firm, partnership, or non-listed company that a person specified in (i), (ii) or (iii) above is able to control shall be deemed to be granted to that person or on his behalf. “Control” is construed according to the definition of “controller” in BO section 2(1).</p> <p>The MA may under BO section 83(4A) permit an AI (subject to such conditions as he may think proper to attach) to grant any of the facilities specified in BO section 83(3) to or on behalf of any of the persons or bodies specified in BO section 83(4) without complying with the limitations set out in BO section 83(1) and (2). According to SPM CR-G-9 “Connected Lending” Paragraph 2.4.2, such permission will only be granted on a very exceptional basis.</p> <p>BO section 85(1) imposes limitations on advances to employees for all AIs. An AI shall not, without the MA’s written consent, provide to any one of its employees any unsecured facility specified in BO section 85(2) to an aggregate amount in excess of one year’s salary for that employee.</p> <p>As recommended in SPM CR-G-9 Paragraph 3.2.1, AIs may, for internal control purposes, wish, where appropriate, to extend the application of their policies on connected lending to persons additional to those specified in BO section 83(4) to cover other parties that may exert considerable influence over the AIs (e.g., its senior management, significant subsidiaries and affiliates) and may, in respect of the types of facilities to connected persons, expand the category of facilities beyond those provided in BO section 83(3).</p> <p>In the case of disclosure, the definition of “related party” under BDR section 32 is wide enough to capture those parties (i.e. senior management and key staff of a bank and its affiliates, the direct and related interests and close family members of the senior management and key staff; and a bank’s subsidiaries and affiliates, and any party over which the bank has control) which were not covered by the definition of related parties under the BO section 83(4).</p> <p>BDR section 32 defines “related party” as a person:</p>
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	<p>(a) who directly, or indirectly through one or more intermediaries—                  (i) controls, is controlled by, or is under common control with, the institution;                  (ii) has an interest in the institution which gives the person significant influence over the institution; or                  (iii) has joint control over the institution;                  (b) who is an associate of the institution;                  (c) who is a joint venture in which the institution has joint control;                  (d) who is a member of the key management personnel of the institution or of any holding company of the institution;                  (e) who is a relative, within the meaning of BO section 79(1), of any individual falling within paragraph (a) or (d), and who, in his dealings with the institution, may be expected to influence or be influenced by that individual;                  (f) who is controlled, jointly controlled or significantly influenced by any person falling within paragraph (d) or (e);                  (g) significant voting power in which resides with, directly or indirectly, any person falling within paragraph (d) or (e); or                  (h) which is an entity that constitutes a post-employment benefit plan for the benefit of—                  (i) the employees of the institution; or                  (ii) the employees of any person falling within any of paragraphs (a), (b), (c), (d), (e), (f) and (g) in relation to the institution.</p> <p>As set out in SPM CR-G-9, AIs should establish a connected lending policy covering, among other things, the categories of connected parties. The policy and any changes thereto are required to be submitted to the HKMA. The BSD reviews the connected lending policy of AIs to ensure that the definition of connected parties included in the policy is appropriate and consistent with the requirements.</p>
<b>EC2</b>	<p>Laws, regulations or the supervisor require that transactions with related parties are not undertaken on more favorable terms (e.g., in credit assessment, tenor, interest rates, fees, amortization schedules, requirement for collateral) than corresponding transactions with non-related counterparties.<sup>64</sup></p>
<b>Description and findings re EC2</b>	<p>SPM CR-G-9 Paragraph 1.5 sets out the basic principle for connected lending by locally incorporated AIs. In particular, AIs are required to have a robust system of checks and balances to monitor compliance with the statutory limits prescribed under BO section 83 for constraining connected lending, uphold impartiality and prevent credit activities of any kind (including on- and off-balance sheet transactions) that override established credit approval policies and procedures when granting credit facilities to connected parties. AIs should also ensure that the terms and conditions of such lending should not be more favorable than those granted to non-connected parties with similar background and creditworthiness.</p> <p>SPM CR-G-9 Paragraph 3.2.1 further provides that AIs should have in place a policy on connected lending that covers interest rates and other terms and conditions applicable</p>

<sup>64</sup> An exception may be appropriate for beneficial terms that are part of overall remuneration packages (e.g., staff receiving credit at favorable rates).



	<p>to connected lending. In general, these should not be more favorable than loans granted to non-connected borrowers under similar circumstances.</p> <p>SPM CR-G-9 section 2.5 and Paragraph 3.2.1 state that the treatment of collateral (or security) accepted for connected lending is consistent with that normally required for non-connected lending.</p> <p>Pursuant to BCR sections 43 and 46, an AI must treat as part of the capital investment that is to be deducted from its Common Equity Tier 1 capital (if certain conditions are met) the aggregate amount of any loans, facilities or other credit exposures granted by the AI to a connected company (as defined under BCR section 35) where the connected company is a commercial entity or a financial sector entity as if such loans, credit facilities or credit exposures were direct capital investments by or capital holdings of the AI, except where the AI demonstrates to the MA's satisfaction that such loans, facilities and credit exposures were granted or incurred in the ordinary course of the AI's business.</p> <p>In examining the connected parties' transactions, the BSD reviews the credit files and records of connected exposures and the relevant systems and procedures for controlling such exposures to make sure that facilities granted to connected borrowers are extended at arm's length and prudent lending criteria are adhered to.</p> <p>It is also a general practice of the BSD to review the information about AIs' related party transactions disclosed in AIs' audited financial statements and/or financial disclosures statements of AIs. If the nature and amount of such transactions give rise to potential prudential concerns, the BSD will require AIs to provide further information to assess whether such transactions are conducted at arm's length terms and commercially justified.</p> <p>Through the review of the Banking Return Form MA(BS)3 "CAR of an AI Incorporated in Hong Kong", the BSD determines that any known credit facilities granted by an AI to its connected companies, which were made outside its ordinary course of business of the AI, have been deducted from the AI's CET1 capital.</p> <p>Separately, as a supervisory measure, the BSD has required AIs concerned to (i) seek the HKMA's prior written consent for the purchase of financial assets from other parts of the banking group or (ii) consult the HKMA in advance for any plan to enter into any new funded risk participation transactions with / purchase any securities backed by assets originated from other intragroup entities. This practice allows BSD to understand the nature and terms of which AIs transact with their connected parties.</p>
<b>EC3</b>	<p>The supervisor requires that transactions with related parties and the write-off of related-party exposures exceeding specified amounts or otherwise posing special risks are subject to prior approval by the bank's Board. The supervisor requires that Board members with conflicts of interest are excluded from the approval process of granting and managing related party transactions.</p>
<b>Description and findings re EC3</b>	<p>SPM CR-G-9 "Connected Lending" Paragraph 3.1.3 specifies that connected lending should be reviewed and approved by the Board of Directors of the AI, the Credit Committee or any other committee with authority delegated from the Board. The</p>

	<p>policy on connected lending of an AI should specify the authority and procedures for approving connected loans (including the extent to which such loans should be subject to approval by the Board). Moreover, directors and credit officers who are connected with the borrowing party should be restricted from taking part in the credit approval process.</p> <p>Similarly, SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" Paragraph 2.6.11 specifies that the Board should have a Board-level conflicts of interest policy and an objective compliance process for implementing the policy. The policy should cover a Board member's responsibility to abstain from voting on any matter where the member may have a conflict of interest or where the member's objectivity or ability to properly fulfill his/her duties to the AI may be otherwise compromised.</p> <p>Requirements on measures to be adopted to prevent or manage conflicts of interest are also set out in SPM CG-1 Paragraph 2.6.10. Such measures include adequate segregation of duties and establishing information barriers, such as physical separation of departments.</p> <p>In examining the corporate governance on connected party lending, BSD assesses whether:</p> <ul style="list-style-type: none"> <li>(i) the Board's oversight of connected lending is adequate;</li> <li>(ii) the delegated authority, if any, to committees or management is appropriate; and</li> <li>(iii) any potential conflicts of interest can be identified and addressed adequately.</li> </ul> <p>In connection with the above, the BSD reviews relevant information, such as Board or relevant committee meeting minutes, information package to the Board or relevant committees, management reports, composition and mandates of the relevant committees as well as the approval records and justification in support of the proposal of write-off, etc.</p>
<b>EC4</b>	The supervisor determines that banks have policies and processes to prevent persons benefiting from the transaction and/or persons related to such a person from being part of the process of granting and managing the transaction.
<b>Description and findings re EC4</b>	SPM CG-1 Paragraphs 2.6.6 and 2.6.7 specify that the Board of an AI should establish, implement and maintain effective policies and procedures to identify, prevent (if possible) and manage actual and potential conflicts of interest. The policy should identify the relationships, services, activities or transactions of an AI in respect of which conflicts of interest may arise and set out the measures for prevention or management of these conflicts. For example, the measures should include steps to prevent directors, senior management and other staff members of the AI who are also active outside the institution (e.g., acting as a director of another commercial entity) from having inappropriate influence within the institution in respect of matters that have some connection with, or touch upon, their outside activities, such as lending to a company of which one of the directors is also a director or a member of the senior management of the AI.

	<p>General requirements for AIs to have policies and procedures to avoid and monitor potential conflicts of interest when lending to connected parties are set out in SPM CG-1 Paragraphs 2.6.13 to 2.6.15. Connected lending should be monitored with particular care and appropriate steps taken to control or mitigate the risks of such transactions. The Board of the AI should ensure that the AI fully understands its legal obligations and the consequences of breaching provisions under the BO in relation to connected lending. Similar care should be taken when the AI grants secured facilities to connected parties, notwithstanding that BO section 83 only applies to unsecured lending.</p> <p>Moreover, according to SPM CG-3 "Code of Conduct", an AI's code of conduct should include the requirements that:</p> <ul style="list-style-type: none"> <li>• no member of staff should grant credit to himself, his relatives or companies in which he or his relatives have a personal interest; and</li> <li>• members of staff should not use the power or authority deriving from their position to gain, or to influence other staff to take any action in order to gain, a personal benefit or an indirect benefit.</li> </ul> <p>SPM CR-G-9 "Connected Lending" covers the implementation of statutory limitations on connected lending applicable to locally incorporated AIs under BO section 83. Paragraph 3.2.1 specifies that directors and credit officers who are connected with the borrowing party should be restricted from taking part in the credit approval process. Relevant control systems and procedures for connected lending should include:</p> <ul style="list-style-type: none"> <li>• a designated independent unit or officer, e.g., compliance officer, to monitor connected lending;</li> <li>• regular management reporting on connected exposures including prompt reporting of any exception to the appropriate level of management;</li> <li>• regular reviews by Internal Audit to check whether established policies, limits and procedures in relation to connected lending are strictly adhered to; and</li> <li>• centralization of connected lending at the AI's head office in Hong Kong to facilitate effective control and monitoring.</li> </ul> <p>In addition to reviewing the prevalence of relevant policies and procedures of AIs, the BSD pays particular attention to the following areas when performing an on-site examination:</p> <ol style="list-style-type: none"> <li>(i) whether terms and conditions of lending to connected parties are more favorable than those granted to non-connected parties with similar background and creditworthiness;</li> <li>(ii) whether a robust system of checks and balances is in place to: <ul style="list-style-type: none"> <li>• monitor compliance with statutory limits;</li> <li>• uphold impartiality; and</li> <li>• prevent connected credit activities of any kind (including on- and off-balance sheet transactions) that override established credit approval</li> </ul> </li> </ol>
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	<p>policies and procedures;</p> <p>(iii) whether there are adequate segregation of duties to ensure maker/checker functions exist to deter persons from benefiting from transactions;</p> <p>(iv) whether adequate and effective management oversight as well as proper approval mechanism for connected parties transactions are in place; and</p> <p>(v) whether compliance and internal audit functions conduct adequate independent checks and reviews to check whether the established policies, limits and procedures in relation to connected lending are adhered to.</p>
<b>EC5</b>	<p>Laws or regulations set, or the supervisor has the power to set on a general or case by case basis, limits for exposures to related parties, to deduct such exposures from capital when assessing capital adequacy, or to require collateralization of such exposures. When limits are set on aggregate exposures to related parties, those are at least as strict as those for single counterparties or groups of connected counterparties.</p>
<b>Description and findings re EC5</b>	<p>BO sections 83(1) and (2) impose the following statutory limits on the provision by an AI incorporated in Hong Kong of any facility specified in section 83(3) (including advances, loans or credit facilities which are unsecured) to or on behalf of any person or body specified in section 83(4):</p> <ul style="list-style-type: none"> <li>• aggregate unsecured lending to or on behalf of any one or more specified persons (including both individuals and corporates): not more than 10 percent of the AI's capital base;</li> <li>• aggregate unsecured lending to or on behalf of specified persons who are individuals: not more than HK\$1 million per person and 5 percent of the AI's capital base.</li> </ul> <p>The aggregate connected exposure limit under BO section 83 (i.e. 10 percent of the capital base) is more stringent than the exposure limit for a single customer group under BO section 81 (i.e. 25 percent of the capital base).</p> <p>In recognition of the fact that capital investments might be structured to resemble credit exposures, pursuant to BCR sections 43 and 46, an AI must treat as part of the capital investment that is to be deducted from its Common Equity Tier 1 capital (if certain conditions are met) the aggregate amount of any loans, facilities or other credit exposures granted by the AI to a connected company, where the connected company is a commercial entity or a financial sector entity, as if such loans, credit facilities or credit exposures were direct capital investments by or capital holdings of the AI, except where the AI demonstrates to the MA's satisfaction that such loans, facilities and credit exposures were granted or incurred, as the case may be, in the ordinary course of the AI's business.</p> <p>There is no provision under the BO or other regulations or guidance that requires an AI to collateralize a connected exposure. Although BO section 83(1) only applies to unsecured lending, care should be taken by the AIs when granting secured credit facilities to connected persons. AIs should closely monitor their secured connected lending to ensure that fluctuations in the value of the collateral will not lead to a breach of BO section 83(1). Under BO section 79(3), a secured facility becomes unsecured if the facility amount exceeds the market value of the assets constituting</p>

	<p>the security that secures the facility.</p> <p>It is stipulated in SPM CR-G-9 Paragraph 3.2.1 that AIs should specify in their policy on connected lending maximum limits that apply to individual connected loans and connected loans in aggregate, on a secured and on an unsecured basis, taking into account the limits specified in the BO sections 83(1) and (2).</p> <p>As mentioned in EC 1, AIs are required to submit their connected lending policy to BSD for review. The BSD ensures that the policy is in line with the statutory limits (covering both aggregate unsecured lending to or on behalf of individual persons/corporates), the requirements under SPM CR-G-9 and other internal prudential limits are included as appropriate.</p> <p>BSD reviews statutory returns to ensure AIs' statutory limits are properly adhered to. Locally incorporated AIs are required to submit to the HKMA annually a list of the names of all companies of which their directors are also directors. The BSD will pay attention to the AIs' exposures to these companies when conducting regular return reviews. It will also collect AIs' Management Information System reports for monitoring AIs' compliance with internal connected exposure limits. In case of breaches of statutory / internal connected exposure limits or failure of the relevant internal control systems were noted, the BSD will factor the incidents into the regular CAMEL rating assessment of AIs and the Supervisory Review Process for determining the statutory minimum CAR of locally incorporated AIs.</p> <p>If the BSD identifies concerns over the credit quality of any connected exposures, it can ask the AI to set aside provision for such lending.</p>
<b>EC6</b>	<p>The supervisor determines that banks have policies and processes to identify individual exposures to and transactions with related parties as well as the total amount of exposures, and to monitor and report on them through an independent credit review or audit process. The supervisor determines that exceptions to policies, processes and limits are reported to the appropriate level of the bank's senior management and, if necessary, to the Board, for timely action. The supervisor also determines that senior management monitors related party transactions on an ongoing basis, and that the Board also provides oversight of these transactions.</p>
<b>Description and findings re EC6</b>	<p>As mentioned in the response to EC 4, the Board of an AI should establish, implement and maintain effective policies and procedures to identify the relationships, services activities or transactions of the AI in respect of which conflicts of interest may arise and set out measures for prevention or management of these conflicts.</p> <p>Relevant specific requirements are set out in SPM CR-G-3 "Credit Administration, Measurement and Monitoring" and SPM CR-G-9 "Connected Lending":</p> <ul style="list-style-type: none"> <li>• AIs should assign a designated independent unit or officer, e.g., compliance officer, to monitor connected lending and to ensure compliance.</li> <li>• AIs should have adequate information systems to measure connected exposures and identify exceptions. The list of connected parties should be updated regularly. Any exceptions should be reported promptly to the appropriate level of management. If the exception is serious or the amount</li> </ul>

	<p>involved is significant, it should be reported directly to the Board of Directors or Audit Committee of the AI.</p> <ul style="list-style-type: none"> <li>connected lending should be reviewed and approved by the Board of Directors, the Credit Committee or any other committee with authority delegated from the Board. The Board should also receive regular reports on the amount of outstanding connected loans, including the amount of connected lending that falls within the scope of BO sections 83(1) and (2).</li> <li>senior management should be provided with up-to-date management information to enable them to direct an AI's credit activities and control the associated risks. Among other things, the information should cover total exposures to groups of related counterparties and connected lending.</li> </ul> <p>The BSD determines that the policies and procedures set out in this EC are in place in AIs through its day-to-day supervision.</p>
<b>EC7</b>	The supervisor obtains and reviews information on aggregate exposures to related parties.
<b>Description and findings re EC7</b>	<p>AIs are required to submit MA(BS)1D to the MA under BO section 63(2), which includes information on the following:</p> <ul style="list-style-type: none"> <li>detailed breakdown of exposures to any non-bank connected party equal to or exceeding 5 percent of the capital base of the AI during the reporting period;</li> <li>aggregate unsecured exposures to non-bank connected parties equal to or exceeding 5 percent of the capital base of the AI during the reporting period;</li> <li>aggregate secured exposures to non-bank connected parties equal to or exceeding 5 percent of the capital base of the AI during the reporting period.</li> </ul> <p>AIs are also required to declare in MA(BS)1F their compliance with various statutory limits under the BO, including the exposure limits under the BO sections 81 and 83 (applicable to locally incorporated AIs) and section 85 (applicable to all AIs).</p> <p>The BSD obtains and reviews the relevant information on aggregate exposures to connected parties regularly. These include statistical returns, MIS reports from the AIs and financial disclosures. In addition to this information, further information, where necessary, would be obtained from AIs to clarify doubts or queries.</p>
<b>Assessment of Principle 20</b>	Largely compliant.
<b>Comments</b>	The HKMA reviews the policies of AIs related to connected lending and reviews the credit files of connected exposures to ensure that facilities granted to connected parties are extended on an arm's length and prudent basis. The BO places restrictions on the amount of unsecured exposures, including loans that an AI may have with a related party; however, the current legal definition of "connected party" (or the equivalent term under the BO) does not explicitly cover an AI's senior management or the senior management of affiliates. In addition, boards of AIs are currently not required to provide prior approval to the write-off of exposures to related parties exceeding specified amounts or otherwise posing special risks to the AI.
<b>Principle 21</b>	Country and transfer risks. The supervisor determines that banks have adequate

	policies and processes to identify, measure, evaluate, monitor, report and control or mitigate country risk <sup>65</sup> and transfer risk <sup>66</sup> in their international lending and investment activities on a timely basis.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor determines that a bank's policies and processes give due regard to the identification, measurement, evaluation, monitoring, reporting and control or mitigation of country risk and transfer risk. The supervisor also determines that the processes are consistent with the risk profile, systemic importance and risk appetite of the bank, take into account market and macroeconomic conditions and provide a comprehensive bank-wide view of country and transfer risk exposure. Exposures (including, where relevant, intra-group exposures) are identified, monitored and managed on a regional and an individual country basis (in addition to the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate countermeasures.
<b>Description and findings re EC1</b>	<p>Pursuant to BO Schedule 7 Paragraphs 10 and 12, the MA must be satisfied that an AI has in place adequate accounting systems and adequate systems of control and is carrying on its business (including any business that is not banking business or the business of taking deposits) with integrity, prudence and the appropriate degree of professional competence and in a manner which is not detrimental, or likely to be detrimental, to the interests of depositors or potential depositors. The manner in which an AI manages country and transfer risks is relevant to whether an AI is meeting these criteria.</p> <p>SPM CR-G-5 "Country Risk Management" provides guidance to AIs on the management of country risk and describes the approach that the HKMA will take in reviewing their risk management and provisioning systems.</p> <p>According to SPM CR-G-5 Paragraph 1.1.1, country risk encompasses all the uncertainties arising from the economic, social and political conditions of a country that may cause borrowers in that country to be unable or unwilling to fulfill their external obligations. SPM CR-G-5 section 1.2 describes in more detail the different types of country risk (including, inter alia, sovereign, transfer and contagion risk) of which AIs should be aware.</p> <p>In reviewing the effectiveness of an AI's country risk management and the adequacy of provisions made, the HKMA will determine whether the AI:</p> <ul style="list-style-type: none"> <li>• has appropriate policies and procedures for the management of country risk;</li> <li>• has a robust system for assessing the country risk in its cross-border exposures;</li> <li>• has proper controls (e.g., through establishing and monitoring country</li> </ul>

<sup>65</sup> Country risk is the risk of exposure to loss caused by events in a foreign country. The concept is broader than sovereign risk as all forms of lending or investment activity whether to/with individuals, corporates, banks or governments are covered.

<sup>66</sup> Transfer risk is the risk that a borrower will not be able to convert local currency into foreign exchange and so will be unable to make debt service payments in foreign currency. The risk normally arises from exchange restrictions imposed by the government in the borrower's country. (Reference document: IMF paper on External Debt Statistics – Guide for compilers and users, 2003.)

	<p>exposure limits) in place to manage the concentration risk associated with such exposures;</p> <ul style="list-style-type: none"> <li>• devotes adequate resources to managing country risk; and</li> <li>• maintains adequate provisions for country risk. (SPM CR-G-5 Paragraph 2.2).</li> </ul> <p>Under SPM CR-G-5 Paragraph 3.2.1, AIs should have a clearly defined policy, documented in writing and approved by the Board, the Credit Committee or senior management under delegated authority, for country risk management and provisioning. Generally, it should set out the AI's business strategy in overseas countries, the parameters under which such business is carried out, its risk appetite and risk tolerances in the light of available financial resources, staff skills and systems for country risk identification, measurement, monitoring, reporting and provisioning.</p> <p>Country risk should be managed on a centralized basis and integrated with an AI's overall credit risk management. AIs with significant cross-border operations should have robust systems for monitoring economic, social and political developments in the countries to which they have exposure.</p> <p>AIs should set exposure limits for individual countries (particularly for countries in emerging markets) and sub-limits (e.g., by region) to manage and monitor country risk. Country exposure limits should apply to all on- and off-balance sheet exposures to foreign obligors.</p> <p>Moreover, in monitoring and measuring country exposures, AIs are expected to ensure that the system is comprehensive enough to capture all significant exposures and detailed enough to permit adequate analysis of different types of risks. At a minimum, the measurement system should be capable of making two separate calculations of the AI's country risk exposures, i.e. with and without risk transfer.</p> <p>Although the SPM module does not contain specific paragraphs on the treatment of intra-group exposures, the latter are implicitly included in overall exposures.</p> <p>In practice, the BSD reviews AIs' policies and processes for controlling country risk as part of its review of the overall credit risk management of AIs. This is done mainly through on-site examinations and off-site review.</p> <p>Relevant policies and processes for the identification, monitoring and control of country risk exposures are assessed in accordance with the standards set out in SPM CR-G-5. In assessing the policies and processes, the BSD considers whether:</p> <ul style="list-style-type: none"> <li>• the policies and processes are commensurate with the country risk appetite, scale of country risk exposures and systemic importance of the AI under review;</li> <li>• the policies have clearly set out how an AI, depending on the nature and scope of its cross-border activities, manages and monitors its risk exposures to different countries;</li> <li>• the monitoring process incorporates an assessment of the macroeconomic and market conditions of the concerned countries;</li> </ul>
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	<ul style="list-style-type: none"> <li>• an AI has put in place effective procedures and MIS reports to facilitate monitoring of its country risk exposures in various dimensions (such as on an individual country basis and on a regional basis);</li> <li>• the process ensures that an adequate amount of impairment allowance is provided to credit exposures that face material country risk.</li> </ul> <p>The BSD reviews whether the policies governing the management of country risks by an AI are subject to review regularly and approved by the Board or a Board-appointed Committee. The results of the assessment are factored into the regular CAMEL rating assessment of AIs and the Supervisory Review Process for determining the statutory minimum CAR of locally incorporated AIs.</p> <p>Given the close economic ties between Mainland China and Hong Kong, AIs in Hong Kong are having more business relationships with Mainland counterparties and therefore increasing exposures to Mainland China. This may potentially pose higher credit risks to AIs. To strengthen its monitoring of AIs' exposures to non-bank Mainland China entities, the BSD has stepped up its supervisory measures. This includes collecting more granular information relating to the size and nature of AIs' non-bank Mainland China exposures by revising the relevant banking returns and introducing various surveys (including the Half-yearly Survey on Mainland Activities).</p> <p>Where AIs are experiencing notable growth in non-bank Mainland China exposures, the BSD ascertains the main drivers (e.g., nature of lending and types of borrowers) and assesses the risk implications. Where necessary, the BSD requires the concerned AIs to take appropriate measures to address their rapid growth in such exposures.</p> <p>During 2012 and 2013, the BSD conducted on-site examinations of AIs with significant growth in non-bank Mainland China exposures. The examinations focused on AIs' underwriting criteria for such exposures as well as the effectiveness of their management oversight and risk controls for such exposures.</p> <p>In addition to its focus on Mainland China, during the recent European sovereign debt crisis, the BSD took initiatives to collect data and evaluate whether AIs were exposed to certain countries (e.g., the amount and types of credit exposures). The information request helped the BSD to quickly evaluate the risk that AIs were facing and to devise proportionate supervisory actions promptly. As a result, the HKMA has since July 2011 taken a series of measures to strengthen the resilience of AIs to withstand the potential contagion impact of a crisis that may be triggered by the European sovereign debt issue with a view to safeguarding the interests of depositors.</p>
<b>EC2</b>	<p>The supervisor determines that banks' strategies, policies and processes for the management of country and transfer risks have been approved by the banks' Boards and that the Boards oversee management in a way that ensures that these policies and processes are implemented effectively and fully integrated into the banks' overall risk management process.</p>
<b>Description and findings re EC2</b>	<p>According to SPM CR-G-5 "Country Risk Management" Paragraph 2.2, in reviewing the effectiveness of an AI's country risk management, and the adequacy of provisions, the HKMA will determine whether the AI:</p>

	<ul style="list-style-type: none"> <li>• has appropriate policies and procedures for the management of country risk;</li> <li>• has a robust system for assessing the country risk in its cross-border exposures;</li> <li>• has proper controls (e.g., through establishing and monitoring country exposure limits) in place to manage concentration risk associated with such exposures;</li> <li>• devotes adequate resources to managing country risk; and</li> <li>• maintains adequate provisions for country risk.</li> </ul> <p>Under SPM CR-G-5 Paragraph 3.2.1, AIs should have a clearly defined policy, documented in writing and approved by the Board, the Credit Committee or senior management under delegated authority, for country risk management and provisioning. There should be procedures in place for the approval of an AI's country risk management and provisioning policy and for ensuring that senior management adheres to that policy and implements appropriate measures to identify, monitor and control country risk (Paragraph 3.1.2). The policy should be reviewed at least annually to determine if it is still appropriate for the AI's business and compatible with changing market conditions (Paragraph 3.2.4).</p> <p>Senior management is responsible for monitoring implementation of the policy and developing detailed procedures, where necessary, to supplement the policy (SPM CR-G-5 Paragraph 3.2.5).</p> <p>In practice, the BSD ascertains whether an AI's risk appetite and country risk management policies are properly approved and its Board and senior management exercise adequate oversight of the implementation of such risk appetite and policies.</p> <p>Where the BSD notices that an AI's exposures to borrower(s) in a country increases significantly, it follows up with the AI on the rationale for such increase and assesses the implication for the AI's country risk management, including whether any increase in country risk limit was deliberated by the Board or its delegated committee and whether such increase has been properly approved by the Board or its delegated committee.</p> <p>Where deficiencies in the oversight exercised by the Board, committee or senior management of the AI are identified, the BSD requires the AI to take timely actions to rectify the issue.</p>
<b>EC3</b>	The supervisor determines that banks have information systems, risk management systems and internal control systems that accurately aggregate, monitor and report country exposures on a timely basis; and ensure adherence to established country exposure limits.
<b>Description and findings re EC3</b>	Pursuant to SPM CR-G-5 "Country Risk Management" Paragraph 3.8.2, in measuring country exposures, AIs are expected to ensure that the system is comprehensive enough to capture all significant exposures and detailed enough to permit adequate analysis of different types of risk.

	<p>AIs should ensure that their internal control systems for country risk management are adequate and the staff responsible for the function are competent and equipped with the necessary knowledge and skills to undertake their duties (SPM CR-G-5 Paragraph 3.4.2).</p> <p>Responsibility for country risk may be assigned either to a senior executive (e.g., a country risk officer) or to an appropriate committee. AIs may also establish a specialized unit or department to analyze country risk, propose country exposure limits and carry out regular country reviews (SPM CR-G-5 Paragraph 3.4.4). The functions of analyzing country risk, setting limits and monitoring the AI's country risk exposures should be carried out by persons independent of the business development function (SPM CR-G-5 Paragraph 3.4.5).</p> <p>AIs should have a system for establishing, maintaining and reviewing country exposure limits. Country exposure limits should be approved annually and revised during the year in response to substantive changes in a country's risk profile (SPM CR-G-5 Paragraph 3.7.2).</p> <p>The BSD ascertains whether an AI's information system can accurately aggregate country exposures in a timely manner. It also determines whether risk management systems and internal controls ensure the AI's adherence to established country exposure limits.</p> <p>In the light of increasing exposure of AIs to non-bank Mainland China entities, the HKMA continues to step up its monitoring of such exposures. For instance, BSD requested AIs to provide their MIS on non-bank Mainland China related exposures in Q2/2013. The assessment of the adequacy of these MIS formed part of the scope of the subsequent thematic examination on non-bank Mainland China exposures. In addition to MIS, the examination covered:</p> <ul style="list-style-type: none"> <li>• whether limits are set for different types of non-bank Mainland China exposures and AIs conduct regular stress tests on non-bank Mainland China exposures using stressful but plausible assumptions to assess the asset quality of such exposures;</li> <li>• the quality and effectiveness of AIs' risk management controls for non-bank Mainland China exposures;</li> <li>• the difference, if any, in the treatment of various counterparties in the credit assessment process (e.g., state owned enterprises vs. private enterprises);</li> <li>• the mechanism for ensuring compliance with the relevant Mainland rules, regulations and legal requirements.</li> </ul>
<b>EC4</b>	<p>There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices that are all acceptable as long as they lead to risk-based results. These include:</p> <p>(a) The supervisor (or some other official authority) decides on appropriate minimum provisioning by regularly setting fixed percentages for exposures to each country taking into account prevailing conditions. The supervisor reviews</p>

	<p>minimum provisioning levels where appropriate.</p> <p>(b) The supervisor (or some other official authority) regularly sets percentage ranges for each country, taking into account prevailing conditions and the banks may decide, within these ranges, which provisioning to apply for the individual exposures. The supervisor reviews percentage ranges for provisioning purposes where appropriate.</p> <p>(c) The bank itself (or some other body such as the national bankers association) sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The adequacy of the provisioning will then be judged by the external auditor and/or by the supervisor.</p>
<b>Description and findings re EC4</b>	<p>SPM CR-G-5 "Country Risk Management" section 4 provides guidance to AIs on the policy and approach for country risk provisioning. According to SPM CR-G-5 Paragraphs 4.1.4 and 4.1.5, AIs should adopt a rigorous process for determining the appropriate level of provisions for their country risk. The process should be documented in the AIs' provisioning policy and approved by the Board, the Credit Committee or senior management with delegated authority, and should generally include the following stages in deciding an appropriate level of provision:</p> <ul style="list-style-type: none"> <li>• identifying countries with current or potential repayment difficulties;</li> <li>• analyzing the nature of those difficulties and the extent of the country's problems; and</li> <li>• determining what proportion of exposures to that country is unlikely to be repaid in full.</li> </ul> <p>As indicated in SPM CR-G-5 Paragraph 2.4, the primary responsibility for maintaining adequate country risk provisions rests with an AI's management. The HKMA does not normally stipulate requirements for the loan classification or provisioning level of exposures to specific countries experiencing repayment difficulties. The amount of country risk provisions set aside by an AI is expected to be justifiable, and properly approved and documented. AIs are expected to agree such provisions, if material, with their external auditors.</p> <p>If the situation warrants, the HKMA can require AIs to provide a fixed percentage of additional provisions on exposures to identified countries or regions. For example, the HKMA imposed country risk provisions on exposures to certain countries during the Asian financial crisis, which were subsequently removed with the improvement in the economic condition in the countries concerned.</p>
<b>EC5</b>	The supervisor requires banks to include appropriate scenarios into their stress testing programs to reflect country and transfer risk analysis for risk management purposes.
<b>Description and findings re EC5</b>	<p>As indicated in SPM CR-G-5 "Country Risk Management" Paragraph 3.10.1, AIs are required to conduct stress-testing analysis of their country risk exposures as a way of monitoring actual and potential risks. Such stress testing should also include co-variance analysis to detect or cater for contagion risk, particularly for countries in the same region.</p> <p>Under special circumstances (e.g., in light of rapidly deteriorating economic/political conditions in a country) AIs should also conduct ad hoc stress tests to make a quick</p>

	<p>assessment of the likely impact on their exposures and financial strength.</p> <p>The BSD conducted a benchmarking exercise on AIs' stress-testing practices in 2011 and shared the sound practices identified with the industry. Most of the AIs covered in the benchmarking exercise had put in place reasonable policies and procedures to guide their stress-testing. One of the sound practices identified, in particular in sizeable local AIs, was the adoption of country-specific scenarios to cater for remote but plausible stress events arising from, for example, projected macro-economic imbalances.</p>
<b>EC6</b>	The supervisor regularly obtains and reviews sufficient information on a timely basis on the country risk and transfer risk of banks. The supervisor also has the power to obtain additional information, as needed (e.g., in crisis situations).
<b>Description and findings re EC6</b>	<p>AIs are required to submit MA(BS)9 on a quarterly basis to the MA pursuant to BO section 63(2). This report includes information on:</p> <ul style="list-style-type: none"> <li>• the amounts of external claims on and liabilities to banks outside Hong Kong by countries and non-bank customers outside Hong Kong by countries;</li> <li>• the amounts of cross-border claims on foreign counterparties (banks, public sector and others) by country for assessing country credit exposures after taking into account risk transferred in or out of a country if they are either: <ul style="list-style-type: none"> <li>○ guaranteed by a party in another country; or</li> <li>○ made with a bank whose head office is located in another country;</li> </ul> </li> <li>• the amounts of country debt provisions set aside in respect of each country.</li> </ul> <p>BDR section 25(1) requires an AI to disclose a breakdown of its cross-border claims by major countries or geographical segments in accordance with:</p> <ul style="list-style-type: none"> <li>• the location of the counterparties; and</li> <li>• the types of counterparties, broken down into banks, public sector entities and others.</li> </ul> <p>Based on the submitted data on MA(BS)9, the BSD assesses the country risk and transfer risk of AIs. The HKMA has invited industry comments on a revised MA(BS)9 on July 2013 with an intention to obtain more granular information on cross border activities. It is expected that once the revision is finalized, the HKMA can help enhance its monitoring of country risk and transfer risk.</p> <p>Separately, in view of the increasing exposures of AIs to non-bank Mainland China exposures that could pose higher credit risks to AIs, the BSD has stepped up its monitoring of such exposures. In this regard, the BSD has obtained more granular information for review. See EC 1 above for details.</p>
<b>Assessment of Principle 21</b>	Compliant.
<b>Comments</b>	The HKMA requires banks to actively manage country and transfer risks and it receives information on a quarterly basis in order to monitor the exposure of banks to such risks. It has recently been giving heightened attention to the risk involved in banks'

	exposure to certain European countries that have been experiencing difficulties, as well as to Mainland China. In addition, the Banking Supervisory Department makes use of the work being done by the HKMA's Financial Stability Surveillance Division and Macro Surveillance Committee, which are responsible for monitoring emerging macro-prudential risks facing the Hong Kong banking sector.
<b>Principle 22</b>	Market risk. The supervisor determines that banks have an adequate market risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions and the risk of a significant deterioration in market liquidity. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate market risks on a timely basis.
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require banks to have appropriate market risk management processes that provide a comprehensive bank-wide view of market risk exposure. The supervisor determines that these processes are consistent with the risk appetite, risk profile, systemic importance and capital strength of the bank; take into account market and macroeconomic conditions and the risk of a significant deterioration in market liquidity; and clearly articulate the roles and responsibilities for identification, measuring, monitoring and control of market risk.
<b>Description and findings re EC1</b>	<p>Market risk is considered to be an inherent risk of an AI in the risk-based supervisory approach currently adopted by the HKMA. While there is currently no standalone guideline that covers all aspects of market risk, there are extensive standards and supervisory guidance applicable to market risk management. Furthermore, there are guidelines that address specific aspects of market risk, namely derivatives, traded instruments, foreign exchange risk management, interest rate risk management, use of internal models to calculate market risk capital and valuation of fair-valued positions.</p> <p>In particular, the SPM requires:</p> <ul style="list-style-type: none"> <li>• A sound and effective risk management system to identify, measure, monitor and control market risk among the various types of risks inherent in all of the activities of an AI, and, where appropriate, hold capital against these risks: SPM SA-1 - Risk-based Supervisory Approach;</li> <li>• The Board and senior management of the AI to ensure that an effective risk management framework is in place to facilitate an integrated approach to managing the AI's firm-wide risks (explicitly including market risk), and the identification and management of all major risks across business activities (which may be non-contractual, contingent or off-balance sheet in nature): SPM IC-1 - General Risk Management Controls;</li> <li>• The Board to approve and establish an overall risk strategy including the AI's risk tolerance / appetite; oversee management in developing policies and practices to manage risk accordingly; and regularly review these risk governance arrangements to ensure that they remain adequate and consistent with the AI's operating environment : SPM CG-1 - Corporate Governance of Locally Incorporated Authorized Institutions;</li> <li>• Risk management policies and procedures to take into account a number of factors including those that reflect the risk profile and systemic importance of the AI, the size, nature and complexity of the AI's business activities, the economic substance of its risk exposures and the results of sensitivity analysis</li> </ul>

	<p>and stress tests and anticipated external changes such as changes in market conditions (SPM IC-1);</p> <ul style="list-style-type: none"> <li>• Adequate governance arrangements, and systems and controls sufficient, to ensure that valuation estimates for all financial instruments measured at fair value are prudent and reliable for financial and regulatory reporting purposes: SPM CA-S-10 - Financial Instrument Fair Value Practices;</li> <li>• Fundamental market risk governance and risk management principles, adopting in full the Basel Committee 1994 guideline: Guideline 12.1 Risk Management Guidelines for Derivatives; and</li> <li>• Detailed guidance on specific, in particular the operational, aspects of trading activities, with particular focus on the trading of derivatives: Guideline 12.2 on Risk Management of Derivatives and Other Traded Instruments.</li> </ul> <p>In practice, the exposure to market risk of most locally incorporated AIs is modest. As at June 2013, risk weighted assets for market risk represented only 4.3 percent of local AIs' total risk weighted assets. The HKMA targets the AIs with significant market risk exposure in relation to capital for on-site treasury examinations, though also confirmed to the assessors that if case teams raised concerns, particularly in relation to internal controls, such AIs would also receive priority attention.</p> <p><i>On-site examinations</i></p> <p>Major areas covered in the treasury on-site examination include, but are not limited to,:</p> <ul style="list-style-type: none"> <li>(i) adequacy of the Board / senior management's involvement in and oversight on this area, as market risk limits should be approved by the Board or Board-level committee, supported by inputs from independent market risk management unit;</li> <li>(ii) appropriateness of measurement and revaluation methodologies, stress-testing framework and their respective underlying assumptions, and limits structure;</li> <li>(iii) effectiveness of risk controls, limit monitoring, reporting and follow-up process;</li> <li>(iv) completeness and timeliness of the reports generated by effective management information system (MIS) that (a) aggregate each and every risk type on a bank-wide basis and (b) enable granular monitoring of risks by products, desks, currencies, tenor, and markets; and</li> <li>(v) coverage of AIs' market risk limits over all types of market risks stemming from all authorized products (including new products approved).</li> </ul> <p>In particular, as specified in the examination checklist, the Treasury team reviews whether AIs' policies and procedures regarding market risk management are compatible with their risk appetite and business strategy as well as changing market conditions by reviewing AIs' business strategy proposal and the market risk limit setting process; role and responsibility of relevant management committees by reviewing the terms of reference, meeting minutes, evidence of timely and regular reporting to the Board etc.; and independency and competence of market risk unit by reviewing organization chart of AIs and CVs of relevant staff members.</p>
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	<p><i>Off-site surveillance</i></p> <p>Coupled with the on-site examinations, the HKMA also performs off-site review of market risk management framework on AIs based on size, risk appetite, risk profile, systemic importance and capital strength by regular collecting and reviewing relevant documents such as business strategies, financial statements, meeting minutes of the Board and relevant committees, MIS reports and relevant regulatory returns.</p> <p>The major areas in the off-site review include, but are not limited to:</p> <ul style="list-style-type: none"> <li>(i) assessing the robustness of market risk management framework by reviewing organization charts, Terms of Reference of relevant committees, MIS reports, and CVs of relevant staff of market risk functions etc. to ensure the appropriate risk assessment, monitoring and control systems are in place;</li> <li>(ii) evaluating the properness of the limit setting process (e.g., sensitivity limits, management action triggers, stop loss limits and other thresholds in the MIS reports);</li> <li>(iii) understanding the business strategy of AIs to assess the suitability of market risk management framework; and</li> <li>(iv) assessing the coverage and usage of AIs' stress testing program to address the potential market risk impacts on businesses due to different stress scenarios including drastic deterioration of market and macroeconomic conditions and market liquidities.</li> </ul> <p>Follow-up action by the HKMA has included requiring an AI to strengthen the oversight of its Board by appointing an independent non-executive director with relevant experience and expertise to the Board and strengthen its risk management function after serious market risk control lapses were discovered in an on-site examination.</p>
<b>EC2</b>	<p>The supervisor determines that banks' strategies, policies and processes for the management of market risk have been approved by the banks' Boards and that the Boards oversee management in a way that ensures that these policies and processes are implemented effectively and fully integrated into the banks' overall risk management process.</p>
<b>Description and findings re EC2</b>	<p>The roles and key responsibilities of the board of directors of an AI in the management of inherent risks which includes market risk faced by the AI are set out in various supervisory guidelines.</p> <p>Notably, the SPM standards covering Corporate Governance and General Risk Management Controls (SPM CG-1 and SPM IC-1 respectively) provide the framework to set out the expectations attached to the Board and which explicitly cover market risk. The Board of an AI should:</p> <ul style="list-style-type: none"> <li>• Ensure that there are adequate risk management systems to identify, measure, monitor and control each of the AI's inherent risks including market risk, and approve and establish an overall risk strategy, including a clearly articulated risk tolerance / appetite commensurate with the AI's operations and strategic</li> </ul>



	<p>goals and risk management and compliance capabilities;</p> <ul style="list-style-type: none"> <li>• Approve key risk management policies that enable firm-wide management of risks and, where applicable, on a group-wide basis, and oversee management in developing policies and practices to manage risk in accordance with the board's strategy and the AI's risk tolerance / appetite;</li> <li>• Establish and oversee a firm-wide risk management framework, which should enable the identification and management of all major risks (including market risk) across business activities;</li> <li>• Ensure that the senior management of the AI have the integrity and relevant technical competence and experiences to manage and supervise the AI's key business and risk control functions, and that their roles, responsibilities, accountability and reporting lines are clearly defined;</li> <li>• Approve a risk management framework developed by senior management based on established risk management strategies, and determine that the risk management framework is properly implemented and maintained by senior management;</li> <li>• Approve a set of limits to control the AI's exposure and ensure the risk limits are in line with the AI's risk appetite and business strategies (in some cases these responsibilities of the board could be delegated to board committee(s));</li> <li>• Ensure the AI's management information systems and infrastructure are sufficiently resourced and supportive of the AI's risk management and reporting needs; and</li> <li>• Ensure robust and independent risk management and control functions are in place.</li> </ul> <p>In addition, Guideline 12.1 and Guideline 12.2 also stipulate similar requirements for Board and senior management oversight on AIs' strategies, policies, procedures and processes for risk management of trading in derivatives and other traded instruments. There is also the requirement that the process of risk management for AIs' derivative activities should be integrated into the AI's overall risk management system (Guideline 12.1).</p> <p><i>On-site examinations</i></p> <p>As noted in EC1 above, review of AIs' market risk management is mainly through on-site examinations by the Treasury team and the main areas covered in these examinations is also noted in EC1.</p> <p>In respect of ensuring Board involvement and oversight, the Treasury team:</p> <ul style="list-style-type: none"> <li>(i) reviews the Terms of reference of the relevant committee, relevant section of the Board/committee meeting minutes, etc. to determine whether AIs' policies and procedures regarding market risk management are properly approved by their Board or a committee delegated by the Board; and</li> <li>(ii) reviews relevant sections of sampled meeting minutes of the Board or Board-level committee and MIS reports presented to the senior management and/or relevant committee, and the approval process of these policies and procedures to determine whether the Board oversees management to ensure these policies and procedures are implemented effectively and fully integrated into</li> </ul>
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	<p>the AIs' overall risk management process.</p> <p><i>Off-site surveillance</i></p> <p>Off-site review includes review of the Board minutes and information package of the Board and minutes of relevant risk department meetings to ensure that:</p> <ul style="list-style-type: none"> <li>(i) market risk related strategies, policies and procedures are properly approved by the Board or a Board-level committee; and</li> <li>(ii) discussions among the responsible parties are conducted to ensure <ul style="list-style-type: none"> <li>• market risk</li> <li>• management policies in place are properly approved and integrated in to the risk management process;</li> <li>• comprehensive factors are considered from various risk departments for key decisions made such as change of risk limits;</li> <li>• market risk management tools in place are used in an effective and consistent manner;</li> <li>• exceptions are recorded, escalated and approved according to sound policies and procedures; and</li> <li>• major issues identified during the course of market risk management should be brought to the attention of the Board and directions given by the Board.</li> </ul> </li> </ul>
<b>EC3</b>	<p>The supervisor determines that the bank's policies and processes establish an appropriate and properly controlled market risk environment including:</p> <ul style="list-style-type: none"> <li>(a) effective information systems for accurate and timely identification, aggregation, monitoring and reporting of market risk exposure to the bank's Board and senior management;</li> <li>(b) appropriate market risk limits consistent with the bank's risk appetite, risk profile and capital strength, and with the management's ability to manage market risk and which are understood by, and regularly communicated to, relevant staff;</li> <li>(c) exception tracking and reporting processes that ensure prompt action at the appropriate level of the bank's senior management or Board, where necessary;</li> <li>(d) effective controls around the use of models to identify and measure market risk, and set limits; and</li> <li>(e) sound policies and processes for allocation of exposures to the trading book.</li> </ul>
<b>Description and findings re EC3</b>	<p><i>Policies and procedures</i></p> <p>According to SPM General Risk Management Controls (SPM IC-1), AIs are required to establish and maintain comprehensive policies and procedures for the management of major risks including market risk to which they are exposed on a firm-wide basis and, where appropriate, on a group-wide basis. The relevant policies and procedures of an AI should be comprehensive covering the identification, measurement, control and reporting of risks, consistent with the AI's risk appetite and strategic objectives, and appropriate to the size, nature and complexity of its activities.</p> <p><i>Information systems</i></p>

	<p>The SPM (SPM IC-1) sets out standards that AI's risk management information systems must meet. Banks are required to establish and maintain a management information system with adequate technological support and processing capacity (even in times of stress) to effectively measure and report on the risks of major business activities within the organization.</p> <p>An effective risk management information system should produce timely, accurate and reliable reports for the Board, senior management and line managers to support decision-making at different levels, and to enable early identification of emerging risks. The SPM module addresses areas including, though not limited to, identification, measurement, and aggregation of data, including also requirements relating to limit excesses and notification of limit breaches.</p> <p>The Board is expected to be responsible for ensuring that the information systems and infrastructure are sufficiently resourced and supportive of the AI's risk management and reporting needs such that adequate oversight of firm-wide risk can be achieved (SPM IC-1).</p> <p><i>Market risk limits</i></p> <p>The supervisory guidance on setting of risk limits to control an AI's exposures to various quantifiable risks associated with its business activities as set out in SPM IC-1 apply to market risk management.</p> <p>In setting these limits, an AI should consider, inter alia, its risk appetite, the size and complexity of its business activities and the sophistication of its products and services. Risk limits should be documented and approved by the Board or its designated committee(s). Risk limits should be clearly communicated to the business units and understood by the relevant staff, limit utilization be closely monitored and any excesses or exceptions promptly reported to senior management for necessary action. The risk limits should also be subject to regular review and reassessment in the light of changes in market conditions or business strategies. Please see also CP15 EC1.</p> <p>With respect to derivatives and other traded instruments, (Guideline 12.2), AIs are expected to set appropriate market risk limits, e.g., notional or volume limits, stop loss limits, gap or maturity limits, options limits and value-at-risk limits, etc. The selection of limits should have regard to the nature, size and complexity of the derivatives operations and to the type of risk measurement system of the AIs. Management is expected to understand the strengths and limitations of different types of limits. The aggregate limits for derivatives activity and the broad structure of the limits should be approved by the Board, though the aggregate limits can then be allocated and sub-allocated by the management (Guideline 12.2).</p> <p><i>Exception tracking and reporting process</i></p> <p>There should be established and approved procedures for the reporting and approval of exceptions to limits, which are generally the responsibilities of the independent risk management function of AIs. Persistent limit breaches should be reported to the Board or senior management and fully investigated. (Guideline 12.2 and SPM IC-1).</p>
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	<p><i>Specific requirements on foreign exchange risk</i> Guidance on the policies and procedures and systems for effective management for identifying, measuring, monitoring and controlling foreign exchange risk (including foreign exchange settlement risk and foreign exchange risk of borrowers) of AIs is set out in the SPM Foreign Exchange Risk Management (TA-2).</p> <p><i>Controls around the use of models</i> For supervisory requirements on the use of models to identify and measure market risk and set limits, please see CP15 EC6.</p> <p>Specifically with respect to derivatives, under Guideline 12.1, it is stipulated that the AIs should regularly assess their risk management models, methodologies and assumptions used to measure risk and to limit exposures. Internal auditors of AIs should evaluate the independence and overall effectiveness of internal controls relevant to measuring, reporting and limiting risks, compliance with risk limits and the reliability and timeliness of information reported to senior management and the Board.</p> <p>The frequency and extent to which an AI should re-evaluate its risk measurement methodologies and models depends, in part, on the specific risk exposures created by their derivatives activities, on the pace and nature of market changes and on the pace of innovation with respect to measuring and managing risks (Guideline 12.1). Annual review is the minimum standard expected for AIs with significant derivative activities.</p> <p>Model assumptions should be evaluated and as necessary adjusted on a continuing basis. AIs should compare estimated market risk exposures against actual behavior, particularly where models require simulations or forecasts of future prices, and investigate and address as appropriate material differences identified.</p> <p>An AI's risk control function should be actively involved in the design, implementation and ongoing assessment of the AI's risk management system, particularly its internal models (Guideline 12.2). This will typically be done at head office level and include the regular back-testing of the measure of market risk against daily changes in portfolio value as well as the review and approval of pricing and valuation models used by the front and back offices. Some of the aforesaid key controls on use of models are highlighted in the supervisory guidance on risk management of foreign exchange risk and interest rate risk (SPM on Foreign Exchange Risk Management (TA-2) and Interest Rate Risk Management (IR-1)).</p> <p><i>Policies and procedures for allocation of exposures to trading book</i> A definition of trading activities is set out in Guideline 12.2: "trading" as activities in market-making, position-taking, arbitrage and trading on behalf of customers. The risk exposures of AIs arising from these activities are expected to be allocated into their trading book. The risk management policies of AIs are required to define the approved trading products and authorized trading activities.</p> <p><i>On-site examinations</i> In the treasury on-site examinations of AIs' treasury and derivative activities, the</p>
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	<p>Treasury team reviews key aspects of the market risk control environment that are defined by the relevant policies and procedures. In practice, the Treasury team examines:</p> <p>(a) <i>Information systems</i> To ascertain whether the market risk control system of AIs is effective in risk identification, aggregation, monitoring and reporting, the Treasury team reviews the following areas:</p> <ul style="list-style-type: none"> <li>(i) reporting structure and management oversight on market risk control within the organization; and</li> <li>(ii) timeliness, frequency, content and quality of the MIS reports, accuracy of the measurement and updatedness of limits shown in system.</li> </ul> <p>(b) <i>Market risk limits</i></p> <ul style="list-style-type: none"> <li>(i) Review of the AI's hierarchy of internal limits (including open position limits for individual currencies, both intraday and overnight where appropriate, as well as on the aggregate basis, say in terms of VaR) for the control of market risks to assess whether the limits are appropriate and proportionate to the AI's size and skills;</li> <li>(ii) Review of the relevant terms of reference, management reports of market risk as well as organization chart and CVs of relevant staff (e.g., market risk unit) to assess effective management oversight; and</li> <li>(iii) Review of documentation of market risk limits as well as the input into relevant control systems in a timely fashion to ensure that they are properly understood, updated and broadcasted by reviewing relevant policies and procedures;</li> <li>(iv) Conduct of system walk-throughs and review of MIS reports generated by the systems, and documents evidencing the broadcast of limit changes.</li> </ul> <p>(c) <i>Exception control</i> Review of the relevant sections of market risk policies and procedures and relevant exception log and approval records to assess whether exceptions are properly captured, approved, documented, and resolved.</p> <p>(d) <i>Risk model controls</i> Risk models' approval and performance are reviewed and assessed in treasury on-site examinations to ensure the controls around these models are effective, independent from front office, and updated if and when key assumptions are changed and/or shortcomings are identified.</p> <p>There are only three banking groups with internal models approved in HKSAR. The HKMA indicated that where banks might wish to use their group's global models, the HKMA emphasized the need of tailoring to the local market conditions. Banks were challenged in particular on data, local market scenarios and on new product processes. Each bank that has received an internal model approval has been revisited within the last year to ensure that it is maintaining the standards required for continued approval.</p>
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	<p>(e) <i>Trading book policies and processes</i> Review of the policies, procedures and other relevant documents (e.g., list of trading portfolios stored in trading system) related to trading book is done to ensure positions are properly allocated between trading book and banking book.</p> <p><i>Off-site surveillance</i> In the off-site review, the HKMA reviews AIs' meeting minutes and information package which includes summary information generated by information systems on market risk exposures prepared for the Board or senior management for their review and/or approval.</p> <p>In addition to reviewing market risk policies of AIs, the off-site review also covers (i) whether market risk limit setting and approval processes reflect the latest business strategy and plans to assess the coherence with the existing market risk management framework and (ii) whether the set limits are properly managed on a daily basis by management.</p> <p>The HKMA obtains market risk exception reports and the documents on escalation and follow-up to ascertain exceptions are properly reported and resolved by senior management or the Board of the AI according to the existing policies and procedures (please see EC 4).</p> <p>The HKMA mainly relies on on-site examinations to ascertain that AIs have policies and procedures in place to allocate exposures to trading book correctly. In practice the HKMA has not found many instances where correct allocation between the banking and trading book was an issue, but confirmed that the on-site teams were watchful for illiquid positions or products that were complex and difficult to price.</p>
<b>EC4</b>	<p>The supervisor determines that there are systems and controls to ensure that banks' marked-to-market positions are revalued frequently. The supervisor also determines that all transactions are captured on a timely basis and that the valuation process uses consistent and prudent practices, and reliable market data verified by a function independent of the relevant risk-taking business units (or, in the absence of market prices, internal or industry-accepted models). To the extent that the bank relies on modeling for the purposes of valuation, the bank is required to ensure that the model is validated by a function independent of the relevant risk-taking businesses units. The supervisor requires banks to establish and maintain policies and processes for considering valuation adjustments for positions that otherwise cannot be prudently valued, including concentrated, less liquid, and stale positions.</p>
<b>Description and findings re EC4</b>	<p>There is extensive regulatory guidance and standards relating to valuation practices, processes and governance. The standards are principally set out in the SPM (Financial Instrument Fair Value Practices - <a href="#">CA-S-10</a>). The module addresses governance, controls and risk management systems of AIs for the valuation of financial instruments measured at fair value. The module reflects up-to-date guidance issued by the Basel Committee (including the enhanced prudent valuation guidance issued under Basel 2.5) and relevant international and local accounting and auditing standards.</p> <p>Additionally, for the locally incorporated AIs that are required to calculate regulatory</p>

	<p>capital for market risk, the BCR establishes requirements for valuation systems, controls and procedures as well as requirements for valuation adjustments when needing to account for limitations of the models, methodology or data used by the AIs in the valuation process, or for other factors such as the liquidity of the instrument. Further guidance on valuation adjustment and the independent review and validation of market risk systems and models (including those for valuation purposes) of AIs is set out in the SPM module on Use of Internal Models Approach to Calculate Market Risk (CA-G-3).</p> <p>The SPM module on General Risk Management Controls (IC-1), which is generally applicable to market risk, establishes requirements for sound valuation practices, particularly in times of stress. This module also specifies that back testing procedures should be used for validation and that the measurement method/model should be subject to periodic update.</p> <p>More specific guidance relating to best practices for timely and effective trade capture and revaluation in relation to derivatives and trading positions is provided in Guideline 12.2.</p> <p><i>On-site examinations</i></p> <p>The Treasury team will examine whether the expected operational control standards are followed. In particular,</p> <ul style="list-style-type: none"> <li>(i) In the course of supervising AIs' treasury operations, the Treasury team reviews policies and procedures on trading position valuation, valuation reports, and the Terms of Reference of the dedicated committee overseeing valuation practice of an AI to ensure that marked-to-market positions are revalued properly and frequently;</li> <li>(ii) The Treasury team also reviews valuation and validation work done by AIs to check whether all eligible transactions are properly captured for revaluation by conducting system walkthrough and reviewing relevant procedures, and whether market data used for valuation are obtained from independent sources by reviewing ownership and controls of data input;</li> <li>(iii) The Treasury team checks if models are used to revalue positions and assess whether AIs' revaluation methodologies and models have been validated by a party independent of the front office operations; and</li> <li>(iv) AIs' policies and procedures and actual practice regarding valuation adjustments (including credit valuation adjustment and other adjustments) are also reviewed during treasury on-site examinations through the review of relevant valuation reports and policies and procedures.</li> </ul> <p>In addition, when an AI applies to use the IMM approach, the HKMA will conduct an on-site examination to check, among other things, whether the AI's internal models are subject to regular, independent validation. The AI must meet the relevant requirements specified in the BCR and the relevant SPM module (CA-G-3) in order to obtain approval.</p> <p><i>Off-site surveillance</i></p>
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	<p>On-site work is supplemented by review of reports by units that are independent from front office (e.g., internal audit, compliance, or other independent units). The HKMA seek to confirm that models used are validated by a function independent of the relevant risk-taking businesses units.</p> <p>For positions that are less liquid, concentrated or otherwise less easy to revalue, the HKMA reviews whether AIs establish policies and procedures to prudently value such positions.</p>
<b>EC5</b>	The supervisor determines that banks hold appropriate levels of capital against unexpected losses and make appropriate valuation adjustments for uncertainties in determining the fair value of assets and liabilities.
<b>Description and findings re EC5</b>	<p>The BCR (see sections 17, 29 and 30) requires locally incorporated AIs (except those AIs that are exempted on a de minimis basis under section 22) to provide regulatory capital for their exposures to market risk (and also to credit risk and operational risk) which covers unexpected loss. The HKMA's market risk capital regime as set out in the BCR aligns with the current Basel capital standards for market risk.</p> <p>Further, the BCR (section 4A) requires AIs to make appropriate valuation adjustments for uncertainties in determining the fair value of the exposures. More detailed guidance on the valuation adjustments is provided in SPM (CA-S-10) Financial Instrument Fair Value Practices.</p> <p>The SPM module on Use of Internal Models Approach to Calculate Market Risk (CA-G-3) specifies that AIs using the internal models approach for market risk should have policies and procedures to ensure prudent valuation of the AI's market risk exposures particularly when there are uncertainties affecting the accuracy of valuation estimates.</p> <p>The SPM module on Supervisory Review Process (CA-G-5) lays down the HKMA's approach to the ongoing monitoring of capital adequacy of AIs, which includes market risk, and includes supervisory standards on the capital adequacy assessment process (CAAP), through which an AI uses to identify and measure the risks it faces and to assess how much capital is needed to support those risks.</p> <p>AIs are also required to use stress testing for the purposes of, inter alia, capital planning under SPM modules for supervisory review process and stress testing (SPM CA-G-5 and SPM IC-5. Please see EC 6 below for details on stress-testing).</p> <p>In terms of supervisory determination, the HKMA reviews capital charge calculation for market risk, to ensure major risks (including market risk) are adequately covered in the context of the Supervisory Review Process. Additionally, the HKMA regularly reviews returns, business strategies and MIS reports to form a view on whether AIs' capital level can support the activities.</p> <p><i>Capital charges for market risk</i> Locally incorporated AIs are expected to conduct rigorous stress testing in order to ensure that their capital level can be maintained at comfortable level even in stressful scenarios.</p>



	<p>The Treasury team conducted a round of thematic on-site examinations in 2013 on selected AIs' compliance with SPM IC-5 on stress-testing requirements.</p> <p>Since the implementation of Basel 2.5 in 2012, AIs which have adopted the IMM approach are required to include the stressed value-at-risk (VaR) in calculating their capital charge against the unexpected losses under a stress scenario. The Stressed VaR should be calculated based on a continuous 12-month period of significant financial stress which is relevant to the AIs and approved by the HKMA.</p> <p><i>Valuation Adjustments</i></p> <p>As noted in EC4 above, during treasury on-site examinations, the Treasury team reviews whether AIs have:</p> <ul style="list-style-type: none"> <li>(i) put in place policies and procedures for identifying the need for and the type of, valuation adjustments to be applied to estimated valuations; and</li> <li>(ii) conducted actual practice to properly implement valuation adjustments by reviewing valuation reports and terms of reference of a dedicated committee</li> </ul> <p>Since the introduction of SPM CA-S-10, the IMM on-site examination team has examined valuation adjustments of trading instruments in the regular review of AIs using the IMM approach.</p> <p>The HKMA confirmed in discussion that it is unusual for AIs in HK to hold significant exotic market risk positions, but some banks have held structured investment on a held-to-maturity basis. In those cases, HKMA has closely monitored the risk management on these products and assessed whether it was necessary for those AIs to set aside any impairment allowance. Upon the HKMA's request, the relevant AIs concerned agreed to set aside impairment allowances accordingly. The HKMA further noted that while local AIs had typically not needed to make valuation adjustments, such institutions would be likely to need specialist help to develop their skills set if their businesses developed in these areas. At the same time, the HKMA was wary of and closely examined the use of vendor products by AIs to ensure that AIs understood the risks in question.</p>
<b>EC6</b>	The supervisor requires banks to include market risk exposure into their stress testing programs for risk management purposes.
<b>Description and findings re EC6</b>	<p>The HKMA's general guidance on stress-testing is set out in SPM module IC-5 on Stress-testing. The overarching requirement is that AIs should develop and implement a sound and effective stress-testing program that covers, among other things, identification and control of all major types of risk associated with the business activities of the AIs (including market risk), complementing other risk management tools, improving capital and liquidity planning, and facilitating decision-making (SPM IC-5). Please see also CP15 EC13.</p> <p>AIs using the internal models approach (IMM approach) to calculate regulatory capital for market risk are also required to have in place a comprehensive stress-testing program that is conducted regularly. The stress-testing results must inform (a) the AIs'</p>

	<p>policies and trading and market risk exposure limits; and (b) the assessment of the adequacy of the AIs' regulatory capital and internal capital for market risk and the AIs' ability to withstand potential future events, or changes in market conditions.</p> <p>An IMM AI that has the MA's approval to calculate the comprehensive risk charge for its correlation trading portfolio is also subject to specific regulatory stress-testing requirements as set out in BCR Schedule 3. The relevant stress-testing requirements relating to the use of the IMM approach mentioned above are further elaborated in SPM module on Use of Internal Models Approach to Calculate Market Risk (CA-G-3).</p> <p>The SPM module on the Supervisory Review Process (CA-G-5) requires AIs to carry out regularly rigorous and forward-looking stress tests, and to integrate relevant results into their CAAP. The HKMA reviews these stress-testing results (including those related to the use of the IMM approach for market risk) to ascertain whether the AIs have sufficient capital to meet the minimum capital requirements under stressed conditions.</p> <p><i>On-site examinations</i></p> <p>The Treasury team examines the internal mechanism (including the types of stress-testing, scenario analysis and their underlying assumptions etc.) employed by an AI to validate its market risk management systems / models.</p> <p>In addition, thematic examinations on AIs' compliance with relevant requirements and standards set out in SPM IC-5 on stress testing have been conducted by the Treasury team.</p> <p>When an AI applies to use the IMM approach to calculate regulatory capital, the HKMA conducts an on-site review to assess the adequacy of the stress testing program. The review covers scenario assumptions adopted, governance of the exercise, reporting of stress test results to the senior management, and use of the results in the AI's risk management process including capital adequacy assessment.</p> <p>To date, no AI has applied for obtaining the HKMA's approval under the BCR to model the comprehensive risk charge for correlation trading portfolio.</p> <p><i>Off-site surveillance</i></p> <p>The HKMA reviews AIs' information package submitted to Board / Committees (e.g., Risk Committees) or risk management reports to senior management, which include information such as stress test on market risks and the respective impact on the AI's profit and loss.</p> <p>A review of stress testing is also carried out as part of the HKMA's Supervisory Review Process. In particular:</p> <ul style="list-style-type: none"> <li>• in addition to historical stress scenarios including the Asian Financial Crisis and the Global Financial crisis, banks are also expected to construct tailor made stress tests that target their specific vulnerabilities; and</li> <li>• bank management are expected to review stress test results critically and take appropriate mitigating actions, including hedging their exposures or setting</li> </ul>
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	<p>aside more capital, should stress test results reach pre-specified management action triggers.</p> <p>Failure to meet HKMA expectations with respect to performance of internal stress tests, or failure to remedy deficiencies as required by the HKMA is reflected in an AI's CAMEL assessment (with implications for capital requirements and also possible offences under the BO).</p>
<b>Assessment of Principle 22</b>	Compliant
<b>Comments</b>	The HKMA has implemented a comprehensive approach to the supervision of market risk, including the introduction of the most recent Basel amendments (Basel 2.5). While overall levels of market risk are modest for the international financial center, at less than 5 percent of risk weighted assets, the HKMA has ensured that all banks with internal models approvals have been subject to reassessment to ensure they continue to meet standards for approval. The HKMA is particularly mindful of the need to tailor models to local market environment and puts a premium on new product processes and internal controls. Looking ahead, the HKMA has engaged with the industry to ensure a close assessment of emerging proposals for the current fundamental review of the Trading Book so that it will be well placed to identify policy or implementation issues and challenges.
<b>Principle 23</b>	Interest rate risk in the banking book. The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate interest rate risk <sup>67</sup> in the banking book on a timely basis. These systems take into account the bank's risk appetite, risk profile and market and macroeconomic conditions.
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require banks to have an appropriate interest rate risk strategy and interest rate risk management framework that provides a comprehensive bank-wide view of interest rate risk. This includes policies and processes to identify, measure, evaluate, monitor, report and control or mitigate material sources of interest rate risk. The supervisor determines that the bank's strategy, policies and processes are consistent with the risk appetite, risk profile and systemic importance of the bank, take into account market and macroeconomic conditions, and are regularly reviewed and appropriately adjusted, where necessary, with the bank's changing risk profile and market developments.
<b>Description and findings re EC1</b>	<p>The Supervisory Policy Manual (SPM IR-1) addresses Interest Rate Risk Management, with a focus on the management and measurement of interest rate risk in the banking book.</p> <p>In particular, the SPM module specifies that AIs' policies, procedures and limits for interest rate risk management should cover the general criteria set out in SPM IC-1 General Risk Management Controls. The minimum standards expected under SPM IC-1</p>

<sup>67</sup> Wherever "interest rate risk" is used in this Principle the term refers to interest rate risk in the banking book. Interest rate risk in the trading book is covered under Principle 22.

	<p>include requirements that such policies, procedures and limits be prepared on a firm-wide basis and, where applicable, on a group-wide basis; take into account the risk profile and systemic importance of the AIs and anticipated external changes and keep pace with the changing environment; and be properly documented, approved by the Board and its designated committees, reviewed and updated.</p> <p>According to SPM IR-1, in assessing the safety and soundness of an AI's interest rate risk management and exposures, the HKMA will, among others:</p> <ul style="list-style-type: none"> <li>• have regard to the nature and complexity of the AI's interest rate risk exposures;</li> <li>• consider the adequacy and effectiveness of Board and senior management oversight;</li> <li>• consider the adequacy of the AI's internal measurement, monitoring, control and management information systems;</li> <li>• analyze the integrity and effectiveness of the AI's interest rate risk management practices and strategies and whether these comply with the objectives and risk tolerance limits approved by the Board; and</li> <li>• consider the appropriateness of the AI's level of interest rate risk in relation to its earnings, capital and risk management systems.</li> </ul> <p>Additionally, there are wide ranging general supervisory requirements that also apply to interest rate risk management, for example the SPM modules relating to corporate governance and risk management process and stress testing.</p> <p><i>Off-site surveillance</i></p> <p>AIs generally have little appetite for IRR and most AIs recorded only a modest level of IRR as measured in terms of either earnings or economic value impact. For instance, as of June 2013, under a hypothetical 200-basis-point interest rate shock, the economic value of local banks' Hong Kong dollar interest rate exposures translated into an impact of less than 1 percent of banks' total capital base. The HKMA attributes this modest impact to the fact that the majority of the banking sector's assets are either floating rate (largely driven by floating rate mortgages) or managed rate based (which are variable rate items for which there are no fixed repricing dates and the interest rates can be adjusted at any time at the discretion of the AI). The HKMA acknowledged in discussion that the structure and risk profile of the sector's balance sheet could change.</p> <p>Given the low level of risk implications of AIs' IRR for the banking sector, assessment is mainly conducted off-site by the HKMA through review of interest rate returns submitted by AIs.</p> <p>Where AIs showing significant increase in IRR exposures are identified, the HKMA follows up with the AIs with a view to determining whether the exposures are consistent with the strategy and appetite set down by the Board of the AIs. Off-site teams of the HKMA also conduct periodic supervisory review process which covers review of IRR (see also ACs 1 and 2).</p>
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	<p><i>On-site examinations</i></p> <p>The Treasury team, which is a specialist team within the HKMA, examines AIs' quality of IRR management according to the details set out in the guideline, to ensure that AIs have put in place the necessary policies and procedures, systems and controls to aggregate and manage IRR on a bank-wide basis.</p> <p>In particular, the Treasury team reviews AIs' policies and procedures related to IRR and whether they are in line with the risk appetite and strategies and whether they are regularly reviewed and approved by the Board or a Board-level committee by reviewing the relevant sections of the meeting minutes, business strategies and IRR risk limits setup etc. to reflect any material changes in AIs' risk profile, business strategy, and market environment. AIs' stress testing program on IRR is also checked to ensure proper IRR management in plausible but severe market and macroeconomic scenarios.</p>
<b>EC2</b>	<p>The supervisor determines that a bank's strategy, policies and processes for the management of interest rate risk have been approved, and are regularly reviewed, by the bank's Board. The supervisor also determines that senior management ensures that the strategy, policies and processes are developed and implemented effectively.</p>
<b>Description and findings re EC2</b>	<p>The role of the Board in the governance of interest rate risk is confirmed in the SPM (IR-1). In particular, this module specifies that:</p> <ul style="list-style-type: none"> <li>• AIs should have adequate and effective Board and senior management oversight of interest rate risk management practices;</li> <li>• the Board should assign responsibility to individuals or units with appropriate experience and expertise, and there should be adequate segregation of duties in key elements of the risk management process to avoid potential conflicts of interest;</li> </ul> <p>Some of the factors taken into consideration by the HKMA in assessing the safety and soundness of an AI's interest rate risk management and exposures as well as oversight by the AI's Board and senior management are reiterated in SPM IR-1 Interest Rate Risk Management but a number of broader SPM modules also apply.</p> <p>The roles and key responsibilities of the Board of an AI in the management of inherent risks (including interest rate risk) faced by the AI are set out in various supervisory guidelines. Among others, the Board of an AI should (SPM CG-1 Corporate Governance of Locally Incorporated Authorized Institutions; SPM IC-1 General Risk Management Controls):</p> <ul style="list-style-type: none"> <li>• Ensure that there are adequate risk management systems to identify, measure, monitor and control each of the AI's inherent risks including interest rate risk, and approve and establish an overall risk strategy, including a clearly articulated risk tolerance / appetite commensurate with the AI's operations and strategic goals and risk management and compliance capabilities;</li> <li>• Approve key risk management policies that enable firm-wide management of risks and, where applicable, on a group-wide basis, and oversee management in developing policies and practices to manage risk in accordance with the</li> </ul>

	<p>Board's strategy and the AI's risk tolerance / appetite;</p> <ul style="list-style-type: none"> <li>• Establish and oversee a firm-wide risk management framework, which should enable the identification and management of all major risks (including interest rate risk) across business activities;</li> <li>• Ensure that the senior management of the AI have the integrity and relevant technical competence and experiences to manage and supervise the AI's key business and risk control functions, and their roles, responsibilities, accountability and reporting lines are clearly defined;</li> <li>• Approve a risk management framework developed by senior management based on established risk management strategies, and determine that the risk management framework is properly implemented and maintained by senior management;</li> <li>• Approve a set of limits to control the AI's exposure and ensure the risk limits are in line with the AI's risk appetite and business strategies (in some cases these responsibilities of the Board could be delegated to Board committee(s));</li> <li>• Ensure the AI's management information systems and infrastructure are sufficiently resourced and supportive of the AI's risk management and reporting needs; and</li> <li>• Ensure robust and independent risk management and control functions are in place.</li> </ul> <p>Some of the factors taken into consideration by the HKMA in assessing the safety and soundness of an AI's interest rate risk management and exposures as well as oversight by the AI's Board and senior management are reiterated in SPM IR-1 "Interest Rate Risk Management."</p> <p><i>Off-site surveillance</i></p> <p>In its regular off-site reviews, the HKMA conducts the following:</p> <ul style="list-style-type: none"> <li>• collecting relevant information to ensure that AIs' strategies and policies for IRR management is properly approved by the Board and subject to annual review;</li> <li>• assessing the effective implementation of IRR management strategies and governing policies by reviewing (i) whether delegation of authorities is clear and enables bank-wide aggregation of IRR, (ii) whether effective management information systems are in place to enable effective monitoring by independent risk management units, and (iii) whether breaches of IRR limits are promptly escalated to the senior management and rectified within reasonable timeframe; and</li> <li>• seeking assistance from the Treasury team, if off-site teams identify potential weaknesses during off-site review. If necessary, the Treasury team will initiate an on-site examination to verify the apparent weaknesses and require the AIs to rectify the weaknesses identified within specific target timelines.</li> </ul> <p><i>On-site examinations</i></p> <p>The Treasury team reviews the meeting minutes of the Board and relevant committees as well as the IRR strategy and policies to ensure that the strategy and policies have been regularly updated and approved by the Board or a Board-level committee.</p>
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	<p>Through the review of AIs' policies and procedures (including internal limits, controls and management information system) and the actual risk management practices and activities of AIs, the Treasury team verifies that strategy, policies and processes approved by the Board or a Board-level committee are developed and implemented properly by the senior management.</p>
<b>EC3</b>	<p>The supervisor determines that banks' policies and processes establish an appropriate and properly controlled interest rate risk environment including:</p> <ul style="list-style-type: none"> <li>(a) comprehensive and appropriate interest rate risk measurement systems;</li> <li>(b) regular review, and independent (internal or external) validation, of any models used by the functions tasked with managing interest rate risk (including review of key model assumptions);</li> <li>(c) appropriate limits, approved by the banks' Boards and senior management, that reflect the banks' risk appetite, risk profile and capital strength, and are understood by, and regularly communicated to, relevant staff;</li> <li>(d) effective exception tracking and reporting processes which ensure prompt action at the appropriate level of the banks' senior management or Boards where necessary; and</li> <li>(e) effective information systems for accurate and timely identification, aggregation, monitoring and reporting of interest rate risk exposure to the banks' Boards and senior management.</li> </ul>
<b>Description and findings re EC3</b>	<p>Guidance is provided under SPM modules covering interest rate risk management as well as general risk management controls (IR-1 and IC-1).</p> <p><i>Interest rate risk measurement systems</i></p> <p>Under SPM IR-1 Interest Rate Risk Management, AIs are required to have interest rate risk measurement systems that encompass all significant causes of such risk. The measurement systems should:</p> <ul style="list-style-type: none"> <li>• evaluate the effect of rate changes on earnings or economic value meaningfully and accurately within the context and complexity of their activities;</li> <li>• be able to flag any excessive exposures;</li> <li>• evaluate all significant interest rate risk arising from the full range of an AI's assets, liabilities and off-balance sheet positions, both trading and non-trading;</li> <li>• employ generally accepted financial models and ways of measuring risk;</li> <li>• have accurate and timely data (in relation to rates, maturities, repricing, embedded options and other details) on current positions;</li> <li>• document the assumptions, parameters and limitations on which they are based. Material changes to assumptions should be documented, justified and approved by senior management;</li> <li>• cover all significant sources of interest rate risk (e.g., repricing, yield curve, basis and option) and assess with special thoroughness: <ul style="list-style-type: none"> <li>- its largest concentrations and positions;</li> <li>- instruments with potentially material effect on an AI's overall position;</li> </ul> </li> </ul>

- instruments with significant embedded or explicit options;
- assess exposures in different currencies.

*Regular review and independent validation*

It is specified in SPM IC-1 General Risk Management Controls that AIs should verify the accuracy and reliability of a risk measurement method or model against the actual results through regular back-testing. The measurement method or model should also be subject to periodic updates to reflect changing market conditions. SPM IR-1 contains similar guidance and further elaborates that AIs with more complex profiles and measurement systems should have their internal models or calculations audited or validated by an independent internal or external reviewer.

Risk management process and related internal controls should be examined and tested periodically. The scope and frequency of audit may vary but should be increased if there are significant weaknesses or major changes or new products are introduced. (see SPM IC-1)

*Risk limit setting*

SPM IR-1 specifies that, among other things, AIs should establish and enforce operating risk limits and other practices that maintain exposures within levels consistent with their internal policies and that accord with their approach to measuring interest rate risk; and that the limits on the effect of rates on an AI's earnings and economic value should reflect the size and complexity of their positions.

SPM IC-1 sets out the minimum standards expected with respect to risk limits which are also applicable to interest rate risk management. These include the standard that risk limits should be (i) in line with an AI's risk appetite and risk profile and suitable to the size and complexity of an AI's business activities and compatible with the sophistication of its products and services; (ii) documented and approved by the Board or its designated committee(s); (iii) subject to regular review, and reassessment in light of changes in market conditions or business strategies; (iv) clearly communicated to the business units and understood by the relevant staff; and (v) subject to close monitoring with regard to their utilization, and any excesses or exceptions be reported promptly to senior management for necessary action.

*Exception tracking and reporting*

There should be established and approved procedures for the reporting and approval of exceptions to limits. The independent risk management function should be responsible for monitoring the use of risk limits and ensuring that the risk exposures of individual business units in respect of various risks (including interest rate risk) are properly aggregated and monitored against the aggregate limits for the AI as a whole. Any excesses or exceptions should be reported to the Board or senior management and fully investigated. (SPM IC-1).

*Information system*

As stated in SPM IR-1, an AI should have an accurate, informative and timely management information system for interest rate risk which is essential to keep senior management and individual business line managers in the picture and to facilitate



	<p>compliance with Board policy. The requirements are further elaborated in SPM IC-1, which states that the system should be capable of, among others, measuring risks in accordance with measurement methods or models adopted, aggregating risk data from various sources of relevant risks from different perspectives (e.g., business line, portfolio and entity) and on various bases (e.g., product, functional, geographical and group basis); reporting excesses in limits and policy exceptions; and producing information at appropriate intervals. Please see also CP 15 EC7.</p> <p><i>On-site and off-site reviews</i></p> <p>To assess the quality and comprehensiveness of AIs' IRR systems, the HKMA conducts reviews from two aspects:</p> <ul style="list-style-type: none"> <li>(i) review of AIs' policies and procedures in respect of their compliance with the relevant standards and sound practices set out in SPM IC-1 and SPM IR-1; and</li> <li>(ii) examination of the actual implementation of the policies and procedures to ascertain compliance with the AIs' policies and procedures.</li> </ul> <p>In particular, the Treasury team in its on-site examinations reviews the IRR policies and processes covering:</p> <ul style="list-style-type: none"> <li>(a) the accurate and complete measurement of IRR within dedicated systems by reviewing the relevant section in IRR policies and procedures, checking MIS reports and conducting system walkthroughs wherever necessary;</li> <li>(b) regular and independent review of models used in IRR management by checking organization charts of the model validation team and relevant documents detailing key assumptions and models;</li> <li>(c) proper limit approval by the Board or a Board-level committee reflecting AIs' risk profile and appetite and capital base, and understood by and communicated to staff by reviewing the limit setting documentation, approval records, limit review process, limit reports and limit updating process;</li> <li>(d) exception handling (tracking, reporting and rectifying) to ensure prompt remedial actions at the appropriate level by reviewing limit exception log, MIS reports, relevant procedure and actual audit trail of exception handling, and relevant sections of meeting minutes of the Board or the Board-level committee; and</li> <li>(e) availability of an effective MIS for IRR management by reviewing the information package prepared for the Board and senior management, MIS reports generated and conducting walk-through wherever appropriate to ensure accurate and timely IRR exposure management and reporting to the Board and senior management.</li> </ul> <p>In addition, the treasury team also reviews AIs' audit plans and audit reports to ascertain the adequacy of audit coverage, frequency and quality of audit in respect of the IRR management function.</p>
<b>EC4</b>	<p>The supervisor requires banks to include appropriate scenarios into their stress testing programs to measure their vulnerability to loss under adverse interest rate movements.</p>

<b>Description and findings re EC4</b>	<p>Three SPM modules principally apply to stress testing in relation to interest rate risk, namely General Risk Management Controls, Interest Rate Risk Management and Stress testing.</p> <p>SPM IC-1 “General Risk Management Controls” section 4.5 and SPM IR-1 “Interest Rate Risk Management” section 6.4 specify that AIs should have adequate systems and capability to conduct comprehensive stress tests on a firm-wide basis to identify possible events or market changes that could have serious adverse effects or a significant impact on their overall risk profiles and financial positions (SPM IC-1). These requirements apply to measuring AIs’ vulnerability to loss in possible stress scenarios affecting interest rates where interest rate risk is one of the major risks faced by AIs (SPM IR-1). The general requirements for stress-testing are set out in SPM IC-5 “Stress-testing.” SPM IC-5 provides examples of risk factors that may be relevant to AIs and SPM IR-1 provides historical and hypothetical examples of stress scenarios for conducting stress tests on interest rate risk. The stress test results must be reviewed regularly by the Board and senior management and taken into account in the setting of policies and limits (SPM IC-1).</p> <p><i>On and off site examination</i></p> <p>The Treasury team verifies proper implementation of stress tests by AIs during on-site examinations. In addition, thematic examinations on AIs’ compliance with relevant requirements and standards set out in the SPM IC-5 on Stress-testing have been conducted by the Treasury team.</p> <p>The HKMA may ask AIs to submit their stress-testing scenarios and results or other relevant internal management reports for off-site monitoring of the AIs’ on-going stress-testing activities.</p>
<b>Additional criteria</b>	
<b>AC1</b>	<p>The supervisor obtains from banks the results of their internal interest rate risk measurement systems, expressed in terms of the threat to economic value, including using a standardized interest rate shock on the banking book.</p>
<b>Description and findings re AC1</b>	<p>Off-site surveillance</p> <p>All AIs are required to submit quarterly the Return of Interest Rate Risk Exposures which facilitates an evaluation of AIs’ level of interest rate risk based on both the earnings approach and the economic value approach, and incorporates the scenario analyses of a standardized 200-basis-point parallel interest rate shock to the AIs’ interest rate risk exposures. The HKMA uses the information to measure the impact of the shock on the economic values of AIs’ interest risk exposures and incorporates the results in the HKMA’s supervisory stress-testing program.</p> <p>Where necessary, the HKMA may request individual AIs to submit additional information such as internal management reports and stress-testing scenarios and results for monitoring purposes.</p> <p>Under the regular Supervisory Review Process (SRP), the HKMA takes into account the impact of individual locally incorporated AIs’ interest rate risks (including the repricing</p>

	<p>risk, basis risk, option risk and yield curve risk) on their earnings and/or economic value as well as the adequacy of AIs' corporate governance and risk management for their interest rate risk in determining their statutory minimum CAR.</p> <p>The HKMA will discuss with the AIs' management if the HKMA has concern about its interest rate risk exposures. Where the situation warrants, an AI may be asked to strengthen its capital position or reduce interest rate risk, or to enhance risk management to better monitor and manage its interest rate risk exposure. The HKMA discussed its monitoring and supervisory response to an AI where lack of sufficient control of interest rate risk had been identified.</p> <p><i>On-site examinations</i></p> <p>When conducting on-site examinations on the interest rate risk management of AIs, the HKMA obtains AIs' stress-testing scenarios and test results for review.</p>
<b>AC2</b>	The supervisor assesses whether the internal capital measurement systems of banks adequately capture interest rate risk in the banking book.
<b>Description and findings re AC2</b>	<p>The HKMA has conducted Pillar 2, SRP assessments since implementing Basel 2 in 2007.</p> <p>To ascertain the adequacy and effectiveness of AIs' CAAP in respect of the interest rate risk in the banking book, the HKMA reviews the relevant policies and procedures, assumptions and methodologies to determine whether there are processes in the CAAP to relate material risks (including interest rate risk in the banking book) to internal capital and capital adequacy goals. The outcome of the CAAP is also reviewed to assess the reasonableness relative to the HKMA's assessment of the risk profile of the AI concerned.</p> <p>Review of an AI's level of interest rate risk exposures vis-à-vis its capital position is also incorporated in the day-to-day risk-based supervision of AIs and the regular CAMEL reviews on the AIs. As mentioned in Additional Criterion 1 of this Principle, the HKMA will discuss with the AI's management if the HKMA has concern about its interest rate risk exposures. Where the situation warrants, the AI may be asked to strengthen its capital position or reduce its interest rate risk.</p> <p>AIs are required to develop or refine their CAAP according to the standards set out in SPM CA-G-5. Details on the factors (such as prepayment risk in residential mortgage loan portfolios) for assessing capital adequacy for interest rate risk in the banking book under SRP are provided in this SPM module. Furthermore, the HKMA will evaluate (SPM IR-1 sections 4.4 and 4.5) AIs' level and trend of interest rate risk exposures, and in particular, whether a locally incorporated AI has adequate capital to support its level of interest rate risk exposures and the risk those exposures may pose to its future financial performance.</p> <p>The HKMA may require AIs to maintain higher minimum CARs (under BO section 97F) if the HKMA believes that the AIs' current capital planning process cannot adequately capture their interest rate risk exposures in the banking book (and/or other risks).</p> <p><i>On-site examinations</i></p>

	In 2011, HKMA conducted a round of thematic examinations on the quality of CAAPs of eight AIs which have substantially established CAAPs. The scope of the examination covered assessment on adequacy of the internal capital measurement systems in capturing major risks (including interest rate risk in the banking book).
<b>Assessment of Principle 23</b>	Compliant
<b>Comments</b>	Interest rate risk is, currently, a low impact risk for the banking sector in HKSAR but the HKMA demonstrates a cautious approach to ensuring that standards of risk management are maintained.
<b>Principle 24</b>	Liquidity risk. The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons. At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards.
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require banks to consistently observe prescribed liquidity requirements including thresholds by reference to which a bank is subject to supervisory action. At least for internationally active banks, the prescribed requirements are not lower than, and the supervisor uses a range of liquidity monitoring tools no less extensive than, those prescribed in the applicable Basel standards.
<b>Description and findings re EC1</b>	<p>Under BO section 102, every AI is required to maintain a liquidity ratio of not less than 25 percent in each calendar month as calculated in accordance with the provisions of BO (Schedule 4 and Part XVIII). Moreover, the MA may require a locally incorporated AI to observe this legal requirement on a consolidated basis (covering its subsidiaries and overseas-branches of the AI) as well as on an unconsolidated basis, as specified by the MA (BO section 102(3A) and (3B)). Under BO section 105, the MA may vary the minimum liquidity ratio for particular AIs.</p> <p>The liquidity ratio (LR) is calculated as the ratio, expressed as a percentage of the net weighted amount of its "liquefiable assets" to its "qualifying liabilities" and, for each calendar month, on the basis of the sum of the net weighted amount of the liquefiable assets and the sum of the qualifying liabilities for each working day of that month. The qualifying liabilities are the sum of (a) the amount by which the total one-month liabilities of relevant banks to the AI are exceeded by its total one-month liabilities to relevant banks, and (b) the total of its other one-month liabilities at the close of business on a working day.</p> <p>To complement the above statutory minimum liquidity ratio requirement, the MA has issued SPM LM-1 Liquidity Risk Management and SPM LM-2 Sound Systems and Controls for Liquidity Risk Management under BO section 16(10).</p>

	<p>SPM LM-1 sets out the general framework adopted by the HKMA for supervising liquidity risk. Under this module, AIs are expected to set limits for the liquidity metrics they employ in monitoring and controlling their liquidity risk exposures, and submit relevant internal liquidity reports to the MA periodically.</p> <p>SPM LM-2 has incorporated the Basel Committee's Principles for Sound Liquidity Risk Management and Supervision issued in September 2008.</p> <p>It should also be noted that the minimum criteria for authorization provided in the BO Schedule 7 Paragraph 7 include, inter alia, the following two criteria in respect of an AI's liquidity position:</p> <ul style="list-style-type: none"> <li>• the AI maintains adequate liquidity to meet its obligations as they will or may fall due; and</li> <li>• maintains a liquidity ratio which complies with the provisions of the BO Part XVIII applicable to it (i.e. the minimum liquidity ratio mentioned above).</li> </ul> <p>Failure to meet the statutory minimum liquidity ratio may call into question whether the AI continues to satisfy the authorization criteria set out in the BO.</p> <p>The HKMA is a member of the Basel Committee and is implementing the Basel 3 liquidity standards (namely the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR)) according to the timetable set out by the Basel Committee.</p> <p>Legislative amendments were made in March 2012, empowering the MA to make statutory rules to implement the regulatory standards set out by the Basel Committee (see BO sections 97H, 97I, 97J and 97K). The HKMA intends to finalize all major policy decisions relating to the LCR within 2013 and complete the rule-making and legislative processes for the new set of Banking (Liquidity) Rules in 2014 for implementation from 1 January 2015. The HKMA also plans to implement in 2015 the liquidity monitoring tools set out in the January 2013 LCR Revision.</p> <p><i>On and off-site examinations</i></p> <p>The HKMA sets and monitors individual "internal" minimum limits on the liquidity ratio, which is more conservative than the statutory 25 percent minimum. Should any AI's liquidity ratio fall close to its internal limit, the supervisory team will enter into discussions with the AI and if necessary, demand remedial actions to restore its liquidity strength within agreed timeframe. Were the statutory liquidity ratio to be breached and failing an appropriate response from the AI, the HKMA, would exercise its powers under BO section 104. As with other breaches of the AI, failure to comply and remedy the situation would expose the AI's management ultimately to fines and imprisonment.</p> <p>The following measures have been adopted from time to time, particularly when material liquidity risks have emerged in the banking sector or individual AIs:</p> <ul style="list-style-type: none"> <li>• increase frequency of reporting – both the liquidity ratio and other liquidity information – the HKMA's experience is that system wide there is a reasonable</li> </ul>
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	<p>standard of systems readiness at present, though some improvement is necessary;</p> <ul style="list-style-type: none"> <li>• raise the internal minimum limit of the liquidity ratio, at least temporarily; and</li> <li>• require individual AIs to exclude (or limit) certain types of “liquefiable assets” in the calculation of liquidity ratio, or even ring-fence some specific transactions conducted by individual AIs. For example, during the recent global financial crisis, the HKMA requested the reduction and in some cases elimination of intra group exposures from the calculation of the liquidity ratio.</li> </ul> <p>In the context of on-site examinations, the HKMA teams will discuss the composition of liquefiable assets in the portfolio to see which criteria are being used to identify these assets (within the definitions permitted under the BO), whether market quotes are available and if so the quality of such quotes. It is the HKMA’s experience to date that AIs typically hold Exchange Fund Bills and Notes that are highly liquid.</p> <p>In addition to the minimum statutory liquidity ratio, the HKMA has also been closely monitoring AIs’ compliance with latest systems and controls requirements consistent with Basel standards. On an industry-wide basis, the HKMA had conducted a round of surveys on “Self-assessment on implementation progress on HKMA SPM LM-2” in mid-2012 for tracking AIs’ implementation progress. Another round of thematic examinations on compliance with SPM LM-2 has also been conducted on local banks and large foreign bank branches in 2013.</p>
<b>EC2</b>	The prescribed liquidity requirements reflect the liquidity risk profile of banks (including on- and off-balance sheet risks) in the context of the markets and macroeconomic conditions in which they operate.
<b>Description and findings re EC2</b>	<p>The HKMA seeks to tailor the liquefiable requirements under the LR (see EC1) to the Hong Kong market environment. For example, to respond to market developments and regulatory changes, the HKMA has issued circular letters to AIs to provide further guidance on the treatment of specific assets and liabilities under the LR. For example, as the renminbi banking business continues to develop in HKSAR, the HKMA has issued a series of circulars since 2004 to clarify the treatment of renminbi assets and liabilities in the calculation of the LR. Furthermore, SPM LM-2 “Sound Systems and Controls for Liquidity Risk Management” sets out requirements in relation to systems and controls for liquidity risk management (please see EC 4 below for details). At the time of the assessment, the HKMA was also on-track to implement the Basel III liquidity standards in Hong Kong.</p> <p><i>On and off-site examinations</i></p> <p>In the course of on-going off-site surveillance or regular review, the HKMA assesses AIs’ liquidity risk profile having regard to relevant factors, such as market and economic developments.</p> <p>Based on the on-site and/or off-site assessment, the HKMA may set out specific liquidity requirements for individual AIs. The specific liquidity requirements applicable to individual AIs may be further revised if warranted by institution-specific circumstances or adverse changes in general market and macroeconomic factors affecting certain AIs.</p>

	<p>For example, in the light of the European sovereign debt crisis, the HKMA considered that the liquidity risk of certain AIs might have increased. To strengthen the resilience of AIs to withstand the potential contagion impact of the crisis with a view to safeguarding the interests of depositors, the HKMA has taken a series of prudential measures since July 2011. For instance, the HKMA has reviewed the composition of the liquefiable assets of the HKSAR branches of banks from selected countries and requested these branches to maintain an appropriate proportion of liquefiable assets to withstand any substantial outflow of deposits from the branch's customers under crisis situations. In response to the HKMA's request, some branches increased their holding of Exchange Fund Bills and Notes issued by the HKMA and other liquefiable assets located in Hong Kong.</p> <p>As another example, the HKMA has stepped up monitoring on AIs' renminbi liquidity position in view of the emerging CNH market. The HKMA has required AIs to submit a monthly report on renminbi liquidity positions. Any issues identified (either from industry-wide trends or individual AIs' positions) are further analyzed and followed up.</p>
<b>EC3</b>	<p>The supervisor determines that banks have a robust liquidity management framework that requires the banks to maintain sufficient liquidity to withstand a range of stress events, and includes appropriate policies and processes for managing liquidity risk that have been approved by the banks' Boards. The supervisor also determines that these policies and processes provide a comprehensive bank-wide view of liquidity risk and are consistent with the banks' risk profile and systemic importance</p>
<b>Description and findings re EC3</b>	<p>The SPM sets out comprehensive expectations of the HKMA in relation to liquidity risk management and the overarching governance expected to be in place around it. For example, the required components of a sound liquidity risk management framework are set out in the SPM (LM-2), though other modules, including Corporate Governance and General Risk Management also apply (CG-1 and IC-1).</p> <p>The liquidity risk management framework is expected to be firm-wide, for example the cash flow projections should address on- and off-balance sheet exposures and covering all major business units and activities, taking into account intragroup and, where appropriate, cross-border liquidity movements.</p> <p>Risk management framework should be developed and implemented by the senior management. The AI must develop a liquidity risk policy statement which should cover risk tolerance as established by the Board; strategy, which should set out the general approach to liquidity (including goals and objectives) and the liquidity risk management policies. Liquidity risk management responsibilities must be clearly defined, including reporting structure and liquidity risk management systems must be in place providing tools for measuring, monitoring, controlling and reporting liquidity risk. A contingency funding plan is also required and should outline strategies for dealing with various types of liquidity crisis.</p> <p>Governance standards (section 2, LM-2) include the requirement that the policy statement be approved by the Board and agreed by the HKMA, and be subject to regular review (at least annually) by the Board to ensure that it remains valid under</p>

	<p>changing circumstances. AIs must consult the HKMA prior to making any material changes to the agreed policy statement.</p> <p><i>On and off-site examinations</i></p> <p>Much of the HKMA assessment process focuses on documentary review: including the terms of reference of the Board and relevant committees such as liquidity management committee, executive committee and audit committee, as well as their meeting minutes. The HKMA expects the minutes to include comments of individual members of the committee including who speaks, the statement of the arguments and whether the positions were or were not supported. Supporting documents for such committees are also examined not least to identify the stance of the risk management. The minutes of such committees to be sufficiently detailed so that the discussion can be followed and the positions taken by individual members of the committee identified.</p> <p>Liquidity management policies and procedures as well as contingency funding plans are also reviewed in order to assess adequacy of oversight, effectiveness of implementation and compliance with standards. The HKMA supplements its documentary reviews with regular supervisory contacts including prudential meetings with senior staff and Board level contact.</p> <p>On-site examinations will include checks on:</p> <ul style="list-style-type: none"> <li>(i) Consistency of AIs' liquidity risk management policies and procedures with the nature, complexity and level of AIs' activities and exposures;</li> <li>(ii) Regular review and approval of AIs' liquidity risk management policies and procedures to determine if they are compatible with AIs' risk appetite and business strategy as well as the changing market conditions;</li> <li>(iii) Approach to managing liquidity in different currencies, across borders, and across business lines and legal entities;</li> <li>(iv) Contingency funding plan, including description of a diversified set of viable, readily available and flexibly deployable potential contingency funding sources and the expected time needed to tap on these sources.</li> </ul>
<b>EC4</b>	<p>The supervisor determines that banks' liquidity strategy, policies and processes establish an appropriate and properly controlled liquidity risk environment including:</p> <ul style="list-style-type: none"> <li>(a) Clear articulation of an overall liquidity risk appetite that is appropriate for the banks' business and their role in the financial system and that is approved by the banks' Boards;</li> <li>(b) Sound day-to-day, and where appropriate intraday, liquidity risk management practices;</li> <li>(c) Effective information systems to enable active identification, aggregation, monitoring and control of liquidity risk exposures and funding needs (including active management of collateral positions) bank-wide;</li> <li>(d) Adequate oversight by the banks' Boards in ensuring that management effectively implements policies and processes for the management of liquidity risk in a manner consistent with the banks' liquidity risk appetite; and</li> </ul>



	<p>(e) Regular review by the banks' Boards (at least annually) and appropriate adjustment of the banks' strategy, policies and processes for the management of liquidity risk in the light of the banks' changing risk profile and external developments in the markets and macroeconomic conditions in which they operate.</p>
<p><b>Description and findings re EC4</b></p>	<p>The SPM (LM-2) sets out the standards for strategy, policies and processes to control and manage liquidity risk.</p> <p>Liquidity risk tolerance: The Board of an AI, which is ultimately responsible for the liquidity risk assumed by the AI and the manner in which the risk is managed, is required to establish the liquidity risk tolerance and ensure that it is clearly articulated and communicated to all levels of management. Moreover, the liquidity risk tolerance should take into account the AI's business strategy, financial condition and funding capacity, and should be appropriate for the AI's role in the financial system. The Board should approve and review at least annually liquidity risk strategies and other significant liquidity risk management policies and systems and ensure that these are properly implemented by senior management.</p> <p>Liquidity risk management strategy and practices: Senior management should develop and implement an effective liquidity risk management strategy, policies and procedure, including intraday liquidity risk management. SPM LM-2 provides guidance on the following aspects of AIs' liquidity risk management:</p> <ul style="list-style-type: none"> <li>• liquidity risk identification, measurement, monitoring and control (section 3);</li> <li>• cash-flow approach to managing liquidity risk (section 4);</li> <li>• liquidity stress-testing (section 5);</li> <li>• liquidity risk management in respect of foreign currency exposures (section 6), funding diversification and market access (section 7), collateral (section 11), contingency funding plan (section 12) and public disclosure (section 13);</li> <li>• maintenance of liquidity cushion (section 8);</li> <li>• intragroup liquidity risk management (section 9); and</li> <li>• intraday liquidity risk management (section 10).</li> </ul> <p>Information systems: AIs are expected to have reliable management information systems that provide the Board, senior management with timely and forward-looking information on their liquidity positions and enable measurement of liquidity needs and control of various aspects of liquidity risk as well as management of collateral positions for day-to-day operations across the AI.</p> <p>Board oversight and review: The Board is also required to maintain effective oversight to ensure that the management team implements policies and processes for the management of liquidity risk in a manner consistent with the banks' liquidity risk appetite established by the Board.</p> <p><i>On and off-site examinations</i> Through its off-site review process the HKMA examines:</p> <ul style="list-style-type: none"> <li>• liquidity risk management policy statements, which include an articulation of</li> </ul>

	<p>the AI's liquidity risk tolerance;</p> <ul style="list-style-type: none"> <li>meeting minutes and information package of the Board and management; and</li> <li>the adequacy of the oversight by the Board in relation to liquidity risk management.</li> </ul> <p>In the on-site examination process, with respect to:</p> <ol style="list-style-type: none"> <li>Articulation of liquidity risk appetite approved by AIs' Boards, the HKMA examines Board documentation including meeting minutes;</li> <li>Day-to-day, and where appropriate intraday, liquidity risk management practices, the HKMA samples management reports. For issues highlighted in these reports (e.g., triggers/limits breached), the HKMA also assesses if senior management and/or appropriate committee(s) gives adequate attention and proper guidance so as to ensure sound liquidity risk management practices. In particular, MIS reports are reviewed on a sampled basis to ensure day-end (and where appropriate intra-day) liquidity positions are monitored and managed properly;</li> <li>Information systems, the HKMA mainly reviews the MIS reports generated by the relevant information systems, taking into account adequacy, frequency, coverage of recipients and follow-up actions (if any) of these reports;</li> <li>Oversight by AIs' Boards, in ensuring effective risk management the HKMA chiefly examines the minutes of the Board or the relevant Board appointed committee, including examining the approvals for policies and procedures; and</li> <li>Strategy, policies and processes, the HKMA again reviews the relevant meeting minutes of the Board or a Board-appointed committee, taking into consideration the periodicity of the review by the AI and approval of the risk tolerance level, triggers/limits, policies and procedures in relation to liquidity risk management.</li> </ol>
<b>EC5</b>	<p>The supervisor requires banks to establish, and regularly review, funding strategies and policies and processes for the ongoing measurement and monitoring of funding requirements and the effective management of funding risk. The policies and processes include consideration of how other risks (e.g., credit, market, operational and reputation risk) may impact the bank's overall liquidity strategy, and include:</p> <ol style="list-style-type: none"> <li>an analysis of funding requirements under alternative scenarios;</li> <li>the maintenance of a cushion of high quality, unencumbered, liquid assets that can be used, without impediment, to obtain funding in times of stress;</li> <li>diversification in the sources (including counterparties, instruments, currencies and markets) and tenor of funding, and regular review of concentration limits;</li> <li>regular efforts to establish and maintain relationships with liability holders; and</li> <li>regular assessment of the capacity to sell assets.</li> </ol>
<b>Description and findings re EC5</b>	<p>The requirements of this EC are set out in the SPM modules on Liquidity Risk Management (LM-1 and LM-2). This includes (non-exhaustively):</p> <ul style="list-style-type: none"> <li>Assessment of the impact of other risks on liquidity – including the requirement for AIs to understand the correlation of liquidity risk with other risks (e.g., credit risk, market risk, operational risk, reputation risk and strategic</li> </ul>

	<p>risk) and how their exposures to these risks affect their liquidity and put in place mitigating controls.</p> <ul style="list-style-type: none"> <li>• Analysis of funding requirements – including the requirement to carry out cashflow analysis and establish a policy to maintain a positive cash position or to generate sufficient cash from an AI's assets or funding sources to cover funding requirements including in a funding crisis. Stress tests are required to cover a range of stress scenarios including institution-specific and market-wide stress scenarios (individually and in combination).</li> <li>• Maintenance of liquidity cushion – AIs are required to maintain a cushion of unencumbered, high quality liquid assets that can be reliably sold or “repoed” to meet liquidity needs in normal and stressed periods. The HKMA expects AIs to maintain such a liquidity cushion as a source of strategic liquidity reserve to be held as insurance against a range of liquidity stress scenarios. This requirement must be met by the end of March 2014 as set out in a circular letter issued in September 2013.</li> <li>• Maintenance of a range of diversified and stable funding sources - including the use of concentration limit in any particular asset, funding source and tenor, as well as management of market access.</li> <li>• Identification and building of strong relationships with current and potential funding providers.</li> <li>• Provision of alternative sources of liquidity under adverse circumstances by development of ability to sell assets or exploring arrangements to obtain liquidity against an AI's assets.</li> </ul> <p><i>On and off site examinations</i></p> <p>Reviews and examinations seek to identify and ensure the following elements:</p> <ul style="list-style-type: none"> <li>• An analysis of funding requirements under alternative scenarios - through assessing cash-flow projection approach in managing liquidity risk on net funding requirements on daily basis (a) under normal business conditions and (b) various stress scenarios. The off-site review covers the on and off balance sheet positions and core business line and activities and a variety of factors under alternative scenarios</li> <li>• The maintenance of liquidity cushion – through reviewing the AI's definitions of unencumbered and high quality liquid assets, as specified in policies and procedures. Thematic reviews have also assessed whether AIs meet the minimum survival period, and whether AIs maintain sufficient liquidity cushion to sustain operations under different stress scenarios;</li> <li>• Diversification in the sources (including counterparties, instruments, currencies and markets) and tenor of funding, and regular review of concentration limits – through review of limits, policies and procedures;</li> <li>• Regular efforts to establish and maintain relationships with liability holders – through review of the AIs' mechanism to obtain reliable quotes and test its funding capacity on a regular basis, especially in the context of contingency funding plan; and</li> <li>• Regular assessment of the capacity to sell assets – through review of the key assumptions (including the capacity to sell different assets and associated haircuts) in assessing AIs' liquidity risk stress testing program.</li> </ul>
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<p><b>EC6</b></p>	<p>The supervisor determines that banks have robust liquidity contingency funding plans to handle liquidity problems. The supervisor determines that the bank's contingency funding plan is formally articulated, adequately documented and sets out the bank's strategy for addressing liquidity shortfalls in a range of stress environments without placing reliance on LOLR support. The supervisor also determines that the bank's contingency funding plan establishes clear lines of responsibility, includes clear communication plans (including communication with the supervisor) and is regularly tested and updated to ensure it is operationally robust. The supervisor assesses whether, in the light of the bank's risk profile and systemic importance, the bank's contingency funding plan is feasible and requires the bank to address any deficiencies.</p>
<p><b>Description and findings re EC6</b></p>	<p>The SPM establishes the requirement to have a contingency funding plan (CFP) that sets out clearly its strategies for addressing emergency situations (LM-2).</p> <p>The CFP is expected to take into account, in particular, liquidity shortfalls estimated from stress tests performed by the AI under institution-specific, market-wide and combined stress scenarios. The CFP should be commensurate with an AI's complexity, risk profile, scope of operations and role in the financial system, and should contain a set of policies, procedures and action plans that prepare an AI to deal with the relevant liquidity stress events assumed in the stress tests, with clearly established lines of responsibility and invocation and escalation procedures. The CFP should also be regularly tested and updated to ensure that it is operationally robust.</p> <p>The essential elements of a CFP are also set out, including (but not limited to) such elements as:</p> <ul style="list-style-type: none"> <li>• contingency funding measures/sources for preserving liquidity and making up liquidity shortfalls in emergency situations;</li> <li>• central bank lending facilities and their relevance (but as secondary sources of liquidity), and (for locally incorporated AIs) the eligibility of their assets for securing funding under the HKMA's LOLR framework (AIs are warned not to assume that such support is automatically available to them during a crisis);</li> <li>• early warning signals/triggering events that will activate the plan</li> <li>• clearly defined roles and responsibilities, and escalation and prioritization procedures to deal with a liquidity crisis situation; and</li> <li>• managing customer/business relationships (including the procedures for determining the priority of customer relationships during a crisis and plans for dealing with staff and the public (such as developing a communication plan) and meeting disclosure obligations.</li> </ul> <p><i>On and off-site examinations</i></p> <p>The HKMA reviews AIs' liquidity contingency funding plan as well as ascertaining whether the contingency plan is regularly reviewed and approved by the Board or a Board-level committee to ensure it is in line with AIs' risk profile and market environment. The CFP is examined both by on-site teams and by the case teams off-site.</p> <p>HKMA reviews have included the following:</p>

	<ul style="list-style-type: none"> <li>• review of AIs' internal drill records and results in the ordinary course of on-site / off-site supervision; and</li> <li>• having engaged some AIs to conduct CFP drills using HKMA-defined stress scenarios.</li> </ul> <p>On-site examinations will address but will not necessarily be limited to:</p> <ul style="list-style-type: none"> <li>• approval authorities and frequency of review of the policies and procedures;</li> <li>• roles and responsibilities, in particular the authority to invoke the contingency plan;</li> <li>• definition of early warning signals and identification and monitoring mechanisms;</li> <li>• definition of severe market disruptions and scenarios;</li> <li>• detailed escalation procedures and action plans;</li> <li>• any regular testing / drill for the contingency funding plan;</li> <li>• availability of potential contingency funding sources and the expected time needed to tap on these sources; and</li> <li>• capability of the AI in generating contingency funding within a reasonable timeframe.</li> </ul> <p>The HKMA has had a focus on ensuring that banks will have access to liquidity in case of need. Some AIs have been subject to close attention in order to improve their planning and ensure that practical arrangements and options are in place. In some instances the case teams have run ad hoc drills.</p>
<b>EC7</b>	<p>The supervisor requires banks to include a variety of short-term and protracted bank-specific and market-wide liquidity stress scenarios (individually and in combination), using conservative and regularly reviewed assumptions, into their stress testing programs for risk management purposes. The supervisor determines that the results of the stress tests are used by the bank to adjust its liquidity risk management strategies, policies and positions and to develop effective contingency funding plans.</p>
<b>Description and findings re EC7</b>	<p>The SPM (LM-2) sets out requirements for a range of conservative stress tests and analysis of the outcome of such tests. Scenarios should cover, at a minimum, institution specific and market-wide stress scenarios (individually and in combination). The scenarios should also cater for short-term and protracted liquidity stresses. AIs should consider the need for additional stress scenarios (or additional levels of severity for scenarios used) based on their individual risk profiles AIs are further required to refer to the SPM module on stress testing (IC-5) for general guidance on the use of stress tests for risk management purposes.</p> <p><i>On and off-site examinations</i></p> <p>In examining the liquidity risk management of AIs in relation to stress-testing, the HKMA reviews include:</p> <ul style="list-style-type: none"> <li>• the key assumptions (e.g., run-off rates of deposits, haircuts of debt securities, interactions with other risks, etc) employed in various stress scenarios;</li> <li>• the design of severe market disruptions and scenarios to ensure AIs' contingency funding plans are effective against stressed scenarios; and</li> <li>• whether and how stress testing results would trigger management discussions</li> </ul>

	<p>and actions in relation to effective liquidity risk management.</p> <p>The HKMA has required AIs to complete a self-assessment survey on implementation progress on LM-2 to substantiate their compliance.</p> <p>The HKMA's findings to date indicate that banks have taken account of experiences in the crisis and factored this into the severity of their scenario analysis.</p> <p>The HKMA is conscious that in the crisis, as has happened at other times, there has been a capital inflow into the banking sector – possibly reflecting repatriation of funds to local residents – which had the capacity to cause ALM mismatches in the banks' balance sheets. The HKMA therefore is encouraging banks to consider the impact of this and is developing liquidity stress tests with this scenario in mind as well as in their ongoing liquidity management strategies.</p>
<b>EC8</b>	<p>The supervisor identifies those banks carrying out significant foreign currency liquidity transformation. Where a bank's foreign currency business is significant, or the bank has significant exposure in a given currency, the supervisor requires the bank to undertake separate analysis of its strategy and monitor its liquidity needs separately for each such significant currency. This includes the use of stress testing to determine the appropriateness of mismatches in that currency and, where appropriate, the setting and regular review of limits on the size of its cash flow mismatches for foreign currencies in aggregate and for each significant currency individually. In such cases, the supervisor also monitors the bank's liquidity needs in each significant currency, and evaluates the bank's ability to transfer liquidity from one currency to another across jurisdictions and legal entities.</p>
<b>Description and findings re EC8</b>	<p>The SPM modules for liquidity risk management and foreign exchange risk management (LM-2 and TA-2) set out requirements on foreign currency liquidity management covering the elements of this criterion.</p> <p>In addition to requirements on systems, strategies, policies and controls, SPM LM-2 requires AIs to set and regularly review internal limits to control the size of cumulative net mismatches over particular time bands (e.g., "next day", "7 days" and "1 month) for each major foreign currency in which they operate, by taking into account factors including but not limited to the amount of foreign currency liabilities that can be swapped through the foreign exchange market to fund local currency assets, or vice versa; and the ability to raise funds in foreign exchange markets, and to transfer surplus liquidity from one currency to another, across jurisdictions and legal entities. SPM TA-2 addresses maturity mismatches between foreign currency positions as a source of liquidity risk.</p> <p><i>On and off-site examinations</i></p> <p>Identification of significant foreign currency liquidity transformation: The HKMA identifies AIs with significant foreign currency liquidity transformation mainly through reviewing prudential returns; management information packages such as those provided to the Board and/or senior management and discussion with the senior management.</p>

	<p>Review of AIs' monitoring of liquidity needs for significant currency: The HKMA assessment is conducted mainly through on-site examinations of AIs' policies and procedures, triggers and limits, MIS reports and meeting minutes and information package for the Board or a Board-appointed committee in relation to liquidity risk management. The HKMA considers various factors including whether currency mismatches are allowed in policies and procedures; and whether triggers and limits are robust and commensurate with AIs' risk appetite.</p> <p>On-site examinations also review liquidity stress testing programs including whether and how stress testing results would trigger management discussions and actions in relation to effective liquidity risk management.</p> <p><i>Significant currencies</i></p> <p><i>Renminbi liquidity risk management</i></p> <p>In the light of the growing size of renminbi balance sheet and the increasing volume of renminbi fund flows between the offshore and onshore centers of the currency, the HKMA regards the readiness of renminbi contingency funding as increasingly important.</p> <p>Hence, the HKMA has stepped up its monitoring of AIs' renminbi liquidity position since 2012, with particular focus on the levels of on-demand renminbi funds. AIs are required to have both a renminbi liquidity risk management policy and renminbi liquidity contingency plan.</p> <p>Additionally, the HKMA expects AIs to take into account factors that may affect the smooth and timely transfer of renminbi funds that are placed with institutions outside HKSAR.</p> <p>The HKMA also expects AIs to include measures to cope with unexpected tightening of renminbi liquidity in the Hong Kong interbank market when drawing up their contingency plans. The HKMA has also required AIs to have in place readily available renminbi repo or swap arrangements with their counterparties. The HKMA has reviewed AIs' renminbi liquidity management policies, contingency plans and stressed scenarios through off-site review and on-site examination / visitation.</p> <p><i>U.S. dollar liquidity risk management</i></p> <p>In view of high U.S. dollar loan growth and concern of possible massive fund outflow due to the anticipated tapering of quantitative easing by the United States, the HKMA took pre-emptive measure by closely monitoring the U.S. dollar liquidity of AIs, (e.g., U.S. dollar loan-to-deposit ratio) to identify potentially more vulnerable AIs and to assess their readiness for U.S. dollar contingency funding if needed.</p> <p>Overall, the HKMA takes a conservative approach to foreign exchange issues in liquidity. For example, AIs seeking to combine U.S. and Hong Kong dollar exposures in their loan-to-deposit ratio calculation, on the grounds of usual functioning of foreign exchange market, would not be (and have not been) granted unless the HKMA is satisfied the internal controls and management skills are strong enough to control the</p>
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	<p>underlying risk. The HKMA has observed that the sector wide foreign exchange mismatch, which is monitored closely, was down considerably after the crisis and also that post-crisis banks were unwilling to take on counterparty risk with their foreign exchange swap counterparties. The periodic inflows of foreign capital that are invested locally continue to create foreign exchange management challenges for the banking sector and which the HKMA is also monitoring.</p>
<b>Additional criteria</b>	
<b>AC1</b>	<p>The supervisor determines that banks' levels of encumbered balance-sheet assets are managed within acceptable limits to mitigate the risks posed by excessive levels of encumbrance in terms of the impact on the banks' cost of funding and the implications for the sustainability of their long-term liquidity position. The supervisor requires banks to commit to adequate disclosure and to set appropriate limits to mitigate identified risks.</p>
<b>Description and findings re AC1</b>	<p>The BO sets an aggregate asset encumbrance limit of 5 percent of the value of a locally incorporated AI's total assets without prior HKMA approval (section 106). This is a legal requirement and every director, chief executive and manager of an AI which contravenes this requirement commits an offence for which each is liable to fines and/or imprisonment.</p> <p>This is a legal requirement which, if contravened by an AI, may result in the AI's directors, chief executives and managers committing an offence for which they are liable to fines and/or imprisonment. The BDR sets disclosure requirements for the total amount of its secured liabilities and the nature and carrying values of its assets used as security. Disclosure is further enhanced under the terms of the SPM module LM-2 which encourages AIs to disclose regularly, and whenever appropriate, sufficient information regarding their liquidity risk management framework and liquidity risk exposures.</p> <p>Asset encumbrance is covered by the quarterly Certificate of Compliance, which requires AIs to certify their compliance with certain sections of the BO, including BO section 106.</p> <p>The HKMA can obtain additional information for review from the AI and may also commission an audit report by an external auditor under section 63(3) of the BO to determine conformity with the limit. Finally the HKMA reviews AIs' financial disclosure statements and/or annual reports, which may contain additional information about their level of encumbered assets.</p> <p>On a closely related point, although the Basel 3 liquidity standards (which include monitoring metrics on available unencumbered assets) have not yet been implemented, the HKMA expects AIs to migrate towards the new standards that will be required as soon as practicable to an extent that is commensurate with their nature, scale and complexity of business. Thematic on-site examinations have been conducted (by the Treasury team) on selected AIs (mainly local incorporated AIs with active retail business) to review the compliance status of the proposed requirements.</p>
<b>Assessment of</b>	Compliant



<b>Principle 24</b>	
<b>Comments</b>	The HKMA has adopted a vigorous approach to liquidity risk supervision. Preparations are well underway for the timely introduction of the Basel liquidity framework and the intensity of on-site examinations and thematic reviews is increasing. The HKMA has a track record of challenging the liquidity assumptions and liquidity risk management behavior of the banking sector and encouraging and enforcing greater conservatism as necessary.
<b>Principle 25</b>	Operational risk. The supervisor determines that banks have an adequate ORM framework that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk <sup>68</sup> on a timely basis.
<b>Essential criteria</b>	
<b>EC1</b>	Law, regulations or the supervisor require banks to have appropriate ORM strategies, policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk. The supervisor determines that the bank's strategy, policies and processes are consistent with the bank's risk profile, systemic importance, risk appetite and capital strength, take into account market and macroeconomic conditions, and address all major aspects of operational risk prevalent in the businesses of the bank on a bank-wide basis (including periods when operational risk could increase).
<b>Description and findings re EC1</b>	<p>At an overarching level, the BO Schedule 7, requires that the MA must be satisfied that an AI has adequate accounting systems and adequate systems of control and is carrying on its business with integrity, prudence, and the appropriate degree of professional competence.</p> <p>Within the SPM, the module on Operational Risk (OR-1) sets out the HKMA's approach and provides guidance to AIs which should, inter alia:</p> <ul style="list-style-type: none"> <li>• develop and maintain an appropriate ORM framework (consisting of appropriate ORM strategies, policies and procedures) that is effective and efficient in identifying, assessing, monitoring and controlling or mitigating operational risk.</li> <li>• align operational strategies, policies and procedures with its overall business objectives and reflect its operational risk profile, size, scope and complexity of business lines and risk appetite.</li> <li>• have relevant policies and procedures in relation to information technology (IT) capabilities and, security and change of IT systems, facilities and equipment.</li> </ul> <p>In general, and also applying to operational risk, the policies and procedures for risk management of an AI should be prepared on a firm-wide basis and, where applicable, on a group-wide basis and based on a comprehensive review of all business activities of the AI (SPM IC-1 "General Risk Management Controls").</p>

<sup>68</sup> The Committee has defined operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk but excludes strategic and reputational risk.

	<p>The module confirms that the Board of an AI has the responsibility for ORM. To discharge this responsibility, the Board should review the risk management framework regularly to ensure that the AI is managing the operational risks arising from external market changes and other environmental factors, as well as the operational risks associated with new products, activities or systems (SPM OR-1).</p> <p>The senior management of an AI, which has the responsibility for implementing the ORM framework approved by the Board, should develop specific policies, processes and procedures for managing operational risk in all of their material products, activities, processes and systems (SPM OR-1).</p> <p>Please see also CP15 ECs 1 and 2.</p> <p><i>On and off-site examination</i></p> <p>The HKMA's specialist on-site examination on ORM focuses on AIs with higher systemic importance and on those regarding which supervisory concerns on ORM have been identified. The review by the specialist team (the ORM team) includes:</p> <ul style="list-style-type: none"> <li>• review of an AI's ORM strategies, policies and procedures; and</li> <li>• determination, through discussion with relevant staff at different levels and sample checks, whether the AI has developed appropriate processes and tools (e.g., risk control self-assessment, key risk indicators) to effectively identify and manage the operational risk.</li> </ul> <p>Selected AIs must prepare and submit, annually, a Supervisory Control Self-Assessment on ORM, "SCSA ORM" which the ORM team reviews. This review covers all retail banks which are all systemically important, as well as foreign banks of higher operational risk. The template which the AIs must use is reviewed and as necessary revised annually.</p> <p>Under the SCSA ORM process, the selected AIs assess the level of compliance of their ORM frameworks against the supervisory requirements set out in SPM OR-1 and provide various operational risk information and data (e.g., ORM policies and guidelines, operational loss data for previous year, etc.).</p> <p>Based on the information submitted by the selected AIs and the relevant external environment (e.g., macroeconomic and market conditions), the ORM team assesses the level of operational risk and risk management framework of the AIs and the emerging trend of operational risk of the industry. The work of the ORM team and the AIs' submission informs the annual CAMEL rating review in respect of operational risk.</p> <p>The assessors were able to review reports from the ORM team, the analysis undertaken as part of the SRP and CAMEL review and the SCSA reports – including the internal review for management of all the AIs' submissions. The HKMA has identified sector wide issues (e.g., relating to some fraudulent practices) in the past and issued best practices guidance to AIs on the basis of this exercise. Also the exercise is used by the HKMA to distinguish which AIs are conducting acceptable practice or whether follow-up and remedial action is needed. Individual feedback is communicated to the AIs concerned.</p>
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<b>EC2</b>	The supervisor requires banks' strategies, policies and processes for the management of operational risk (including the banks' risk appetite for operational risk) to be approved and regularly reviewed by the banks' Boards. The supervisor also requires that the Board oversees management in ensuring that these policies and processes are implemented effectively.
<b>Description and findings re EC2</b>	<p>As laid out in the SPM module on Operational Risk (OR-1), the responsibility for ORM ultimately rests with the Board of an AI. To discharge this responsibility, the Board, or its delegated committees, should, among other things,</p> <ul style="list-style-type: none"> <li>• approve and periodically review the AI's corporate framework to explicitly manage operational risk (such framework to include ORM strategy, policies and procedures, see SPM OR-1); and</li> <li>• ensure that the senior management is taking necessary steps to implement appropriate policies, processes and procedures within the AI's different lines of business, based on the principles under the Board-approved risk management framework.</li> </ul> <p>The HKMA primarily determines whether there is full and appropriate Board engagement and oversight through its on-site examinations and review of SCSA ORM.</p> <p>In particular, the ORM team obtains the following information during on-site examination and SCSA ORM for assessing whether an AI's Board actually approves and reviews regularly the AI's ORM frameworks and the Board oversees the implementation of the framework.</p> <ul style="list-style-type: none"> <li>• terms of reference of the Board and relevant delegated committees under the Board;</li> <li>• meeting minutes of the Board or relevant delegated committees;</li> <li>• management reports on the AI's overall operational risk profile submitted to the Board or relevant delegated committees;</li> <li>• strategies, policies and procedures for ORM, and the approvals of these documents; and</li> <li>• internal audit reports on the AI's ORM framework.</li> </ul> <p>In addition, the ORM team reviews, during its on-site examinations, the actual practices and processes of ORM of an AI against its established policies to validate that the ORM framework approved by the Board is properly implemented by the senior management.</p> <p>In discussion the HKMA indicated that, sector wide, Boards are seen as active in relation to operational risk. Projects to measure capital based on Basel II advanced measurement approach in relation to this risk are more challenging however but the HKMA, based on six years of on-site examinations for operational risk, pays attention to whether firms are developing appropriate expertise for this purpose. The assessors were able to review files confirming the HKMA's approach.</p>
<b>EC3</b>	The supervisor determines that the approved strategy and significant policies and processes for the management of operational risk are implemented effectively by

	management and fully integrated into the bank's overall risk management process.
<b>Description and findings re EC3</b>	<p>Senior management responsibility for ORM framework which is approved by the Board is articulated in the SPM (OR-1)</p> <p>Senior management is expected to define the AI's organizational structure for ORM and communicate individual roles and responsibilities to staff at all levels in the AI (SPM OR-1).</p> <p>Integration of the ORM into the overall risk management framework of the AI is required under the broader module (SPM IC-1 on General Risk Management Controls).</p> <p>Through on-site examinations and SCSA ORM, the ORM team obtains and reviews various internal documents of an AI against its actual practices to assess the quality of implementation and the degree of integration into the overall risk management process. These internal documents include:</p> <ul style="list-style-type: none"> <li>• minutes of the management meetings;</li> <li>• management reports submitted to the Board or relevant delegated committees, senior management and line management related to ORM;</li> <li>• approved policies and procedures for ORM;</li> <li>• internal audit reports; and</li> <li>• management letters from external auditors, if any.</li> </ul> <p>Additionally, the HKMA obtains AIs' high-level risk management policies, procedures and limit structures for off-site reviews to assess whether they, as a whole, capture all the material risk types facing the AI (including operational risk) and whether they are integrated into the AI's overall risk management processes. In particular, the HKMA assesses whether specialized committees (e.g., risk management committee) are established at Board-level or management level to discuss and resolve issues concerning different types of risks (including operational risk), and consolidate a firm-wide risk profile of the AI across all material risk types. In file review the assessors saw evidence of the HKMA following up these issues.</p>
<b>EC4</b>	The supervisor reviews the quality and comprehensiveness of the bank's disaster recovery and business continuity plans to assess their feasibility in scenarios of severe business disruption which might plausibly affect the bank. In so doing, the supervisor determines that the bank is able to operate as a going concern and minimize losses, including those that may arise from disturbances to payment and settlement systems, in the event of severe business disruption.
<b>Description and findings re EC4</b>	<p>The HKMA has a supervisory objective to help ensure that AIs have workable and well thought through business continuity plans (BCP) to protect all the critical areas of their business and to cope with prolonged disruptions. (SPM TM-G-2 on Business Continuity Planning)</p> <p>Each AI is expected to have in place contingency and business continuity plans, having regard to the nature, scale and complexity of its business activities (SPM modules OR-1 and IC-1).</p> <p>Further, under the SPM module on General Principles for Technology Risk</p>

	<p>Management (TM-G-1), AIs are required to develop an IT disaster recovery plan for timely resumption of critical application systems and technology services.</p> <p>The HKMA has a dedicated specialist team with expertise in BCP for assessing the quality and adequacy of AIs' BCP against the best practices set out in SPM TM-G-2 through off-site reviews and on-site examinations. The assessors were able to review reports and summaries carried out by the team.</p> <p>Off-site reviews include assessing AIs' status of compliance with SPM TM-G-2 through their information submitted in the annual SCSA BCP. Under the SCSA process, AIs' internal auditors or an independent party with relevant BCP expertise are required to assess the compliance level of their institutions' controls and actual practices against the regulatory requirements and sound practices set out in SPM TM-G-2.</p> <p>The SCSA process has covered all retail banks as well as selected AIs that are regarded as having a higher operational risk. For the majority of AIs covered by SCSA BCP, the HKMA has conducted desktop reviews and on-site examinations to examine the independence and expertise of the parties that prepared the SCSA results, and the reasonableness of the results on a sample basis.</p> <p>The HKMA has also required retail banks and selected foreign banks with material capital market operations to demonstrate how to cope with the event that they could not have access to their main offices in the central business district at the same time.</p> <p>The on-site examination, as listed in the examination checklist for BCP, covers the following areas:</p> <ul style="list-style-type: none"> <li>• senior management oversight;</li> <li>• policies and procedures;</li> <li>• business impact analysis and recovery strategy;</li> <li>• crisis management;</li> <li>• technology recovery;</li> <li>• development of BCP;</li> <li>• alternate sites for business and technology recovery;</li> <li>• contingency measures for influenza pandemic; and</li> <li>• testing and maintenance of BCP.</li> </ul> <p>The assessors were able to review the on-site examination checklist and confirm its coverage and also that the template is designed to ensure coverage of scope as opposed to a "tick box" confirmation or compliance exercise. It would be necessary for an examiner to have the relevant skills and experience in order to be able to use the "checklist" in conducting the examination.</p> <p>For the above on-site examinations, the HKMA performs sample checking to support its work (e.g., cross-checking the BCP arrangements of AIs' payments and settlement operations, branch operations).</p> <p>Both the BCP on-site examination and the SCSA BCP cover all the key areas stipulated</p>
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	in SPM TM-G-2 as the assessors were able to confirm from file review.
<b>EC5</b>	The supervisor determines that banks have established appropriate information technology policies and processes to identify, assess, monitor and manage technology risks. The supervisor also determines that banks have appropriate and sound information technology infrastructure to meet their current and projected business requirements (under normal circumstances and in periods of stress), which ensures data and system integrity, security and availability and supports integrated and comprehensive risk management.
<b>Description and findings re EC5</b>	<p>In light of the increasing dependency on technology to deliver banking services, the HKMA developed two SPM modules on the operational risk arising from IT: General Principles for Technology Risk Management and Supervision of E-banking (TM-G-1 and TM-E-1 respectively).</p> <p>The SPM module on Technology Risk Management (TM-G-1) sets out the IT governance. Among the requirements the AI is expected to meet are the following:</p> <ul style="list-style-type: none"> <li>• the development of a set of IT control policies approved by the Board;</li> <li>• clear IT organization structure and related job descriptions of individual IT functions documented and approved by senior;</li> <li>• proper segregation of duties within and among various IT functions;</li> <li>• regular review on IT strategy by the Board or its designated committee and senior management; and</li> <li>• establishment of a function which is responsible for implementing and managing the technology risk management process (i.e. TRM function).</li> </ul> <p>SPM TM-G-1 also specifies the protection of confidential information. AIs should develop control procedures and baseline security requirements to safeguard application programs, operating systems, system software and databases. Additionally, AIs should put in place an effective change management process to ensure the integrity and reliability of the production environment.</p> <p>To cope with higher business volume under normal circumstances and in period of stress, AIs should ideally formulate a service level agreement with business units to cover system availability and performance requirements, capacity for growth and the level of support provided to users and ensure that adequate procedures are in place for managing the delivery of the agreed technology support and services (SPM TM-G-1).</p> <p>Supervisory determination takes place through review of information technology policies and processes of AIs during on-site examinations and off-site reviews. It should be noted that the SCSA process is performed once a year and is an exhaustive and closely documented process.</p> <p>The HKMA has a specialist team to conduct in-depth reviews of information technology risk management systems of AIs as well as of e-banking. In these reviews, the team performs sample checking to support its work (e.g., whether the actual controls of critical IT systems and practices are in line with applicable TRM and e-</p>

	<p>banking polices of banks),</p> <p>The reviews for technology risk management (TRM), cover the following areas:</p> <ul style="list-style-type: none"> <li>• IT organization, governance and management awareness;</li> <li>• policies and procedures;</li> <li>• internal IT audit function;</li> <li>• TRM function and security management;</li> <li>• protection of customer data stored in computer equipment;</li> <li>• problem management and IT incidents management process;</li> <li>• physical and environmental controls;</li> <li>• technology-related outsourcing;</li> <li>• system development and change management controls;</li> <li>• IT operations controls;</li> <li>• business continuity planning;</li> <li>• performance monitoring, capacity planning and resiliency of critical systems and network infrastructure.</li> </ul> <p>Besides on-site examinations, selected AIs submit the results of their annual SCSA on TRM and e-banking. AIs' internal auditors or an independent party with relevant expertise assess the compliance level of their institutions' controls and actual practices against the regulatory requirements and sound practices set out in SPM TM-G-1 and TM-E-1. As noted above, the SCSA process covers all retail banks as well as selected AIs regarded as having a higher operational risk in IT aspect. For the majority of AIs covered by SCSA, the HKMA conducts desktop reviews and on-site examinations to review the independence and expertise of the parties that prepared the SCSA, and the reasonableness of the results on a sample basis.</p> <p>In addition, AIs are required to demonstrate to the HKMA that adequate due diligence and risk controls have been put in place before launching new or enhanced e-banking services or major technology-related initiatives (such as data centre re-location, core banking system migration or technology outsourcing). In particular, AIs conduct an independent assessment on certain technology-related initiatives of higher risks beforehand.</p>
<b>EC6</b>	<p>The supervisor determines that banks have appropriate and effective information systems to:</p> <ol style="list-style-type: none"> <li>(a) monitor operational risk;</li> <li>(b) compile and analyze operational risk data; and</li> <li>(c) facilitate appropriate reporting mechanisms at the banks' Boards, senior management and business line levels that support proactive management of operational risk.</li> </ol>
<b>Description and findings re EC6</b>	<p>The SPM module on General Risk Management Controls (IC-1) requires that AIs should establish and maintain a management information system with adequate technological support and processing capacity to effectively measure and report on the risks (including operational risk) of major business activities within the organization. An effective risk management information system should produce timely,</p>

	<p>accurate and reliable reports for the Board, senior management and line managers to support decision-making at different levels, and to enable early identification of emerging risks.</p> <p>AIs are further expected to take reasonable steps to ensure that the risk management systems put in place to identify, assess, monitor and control operational risk are adequate for that purpose (SPM OR-1). AIs are expected to implement a process to monitor their operational risk profiles and material exposures to losses on an on-going basis (SPM OR-1 ORM). The process should include both qualitative and quantitative assessment of an AI's exposure to all types of operational risk. Senior management should ensure that regular management reports on operational risk are received by the relevant level of management, on a timely basis and in a form and format that will aid in the monitoring and control of their business areas. The management reports are expected to contain operational risk data relevant to decision-making.</p> <p>The ORM team assesses the appropriateness and effectiveness of AIs' information systems for monitoring operational risk through on-site examinations and SCSA ORM. In the SCSA ORM, the information submitted by selected AIs includes:</p> <ul style="list-style-type: none"> <li>• policies and procedures for the ongoing process to monitor the operational risk profile and exposures of individual AIs;</li> <li>• management reports in relation to operational risk provided to the Board, senior management and line management.</li> </ul> <p>In conducting the on-site examinations, the ORM team assessment includes the following areas:</p> <ul style="list-style-type: none"> <li>• implementation of an appropriate process for ongoing monitoring of the operational risk profile and exposures of an AI;</li> <li>• establishment of appropriate indicators by an AI that provide management with early warning of operational risk issues;</li> <li>• adequacy and timeliness of the management reports provided to the Board, senior management and line management for their evaluation of an AI's operational risk profile;</li> <li>• quality of operational risk information contained in the management reports of an AI;</li> <li>• adequacy of the process in capturing the data of operational loss and incidents within an AI.</li> </ul> <p>In addition, the supervisory case teams collect information, based on a list of MIS reports with details on the reporting frequency and recipients of the reports, and the information package to the Board and/or designated committees, during off-site reviews for assessing the adequacy of AIs' MIS information in this area.</p> <p>The assessors discussed the interaction among the specialist teams and case teams and the follow-up that the supervisors conducted with AIs based on the information in the SCSA and on-site examinations. AIs with whom the assessors met indicated that the HKMA had appropriate specialists for the on-site work.</p>
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<b>EC7</b>	The supervisor requires that banks have appropriate reporting mechanisms to keep the supervisor apprised of developments affecting operational risk at banks in their jurisdictions.
<b>Description and findings re EC7</b>	<p>In conducting on-site examinations on AIs' ORM, the ORM team and IT specialist team review the relevant operational and IT incident recording and escalation procedures of the AIs to assess whether operational and IT risk events would be promptly captured and significant events would be reported in a timely manner to relevant parties (e.g., the senior management or regulators).</p> <p>AIs are required to notify the HKMA of any events that may have significant impact on their operations (SPM OR-1). Such events would include:</p> <ul style="list-style-type: none"> <li>• a significant operational loss/ exposure that has been incurred/ identified;</li> <li>• a significant failure in their systems or controls;</li> <li>• an intention to enter into an insourcing/ outsourcing arrangement in respect of a banking related business area (including back office activities), or to make changes to or amend the scope of their insourcing / outsourcing of such areas;</li> <li>• any significant changes in organization, infrastructure or business operating environment; and</li> <li>• the invocation of a business contingency plan.</li> </ul> <p>In addition, the HKMA issued a circular letter on incident response and management procedures in 2010. The HKMA requires AIs to promptly report incidents that could have operational and reputational risk implications for the AIs. Typical examples of incidents to be reported include disruptions to customer services (e.g., Automatic Teller Machines, internet banking), leakage of customer data (e.g., due to internal control deficiencies), and staff fraud (e.g., rogue traders). AIs are required to submit a high level report as soon as possible as well as the rectifying actions taken or to be taken and may, if necessary be required to file a more comprehensive incident report. In discussion, the HKMA indicated that AIs were alert to issues that might impair their reputation and that they were conscious that any operational issue affecting the retail customer's interface with the bank (e.g., ATM failures or on-line banking disruptions) would lead to unwelcome media attention.</p>
<b>EC8</b>	<p>The supervisor determines that banks have established appropriate policies and processes to assess, manage and monitor outsourced activities. The outsourcing risk management program covers:</p> <ol style="list-style-type: none"> <li>(a) conducting appropriate due diligence for selecting potential service providers;</li> <li>(b) structuring the outsourcing arrangement;</li> <li>(c) managing and monitoring the risks associated with the outsourcing arrangement;</li> <li>(d) ensuring an effective control environment; and</li> <li>(e) establishing viable contingency planning.</li> </ol> <p>Outsourcing policies and processes require the bank to have comprehensive contracts and/or service level agreements with a clear allocation of responsibilities between the outsourcing provider and the bank.</p>
<b>Description and</b>	The HKMA uses both on-site and off-site approaches to determine the adequacy of

<p><b>findings re EC8</b></p>	<p>AIs' risk management programs for outsourcing arrangements.</p> <p><i>On-site examination</i></p> <p>Areas that are reviewed during on-site examinations by the specialist teams ORM and TRM include:</p> <ul style="list-style-type: none"> <li>• AIs' due diligence for selecting the service providers (e.g., whether the service providers have sufficient resources and expertise to comply with the substance of the AIs' control policies);</li> <li>• policies and procedures for outsourcing;</li> <li>• outsourcing contracts and service level agreements;</li> <li>• work conducted by the AIs to manage and monitor the quality of services (including security management as well as internal controls) provided by service providers;</li> <li>• contingency plan and testing with service providers.</li> </ul> <p><i>Off-site surveillance</i></p> <p>AIs must notify the HKMA before outsourcing activities and must demonstrate to the satisfaction of the HKMA that the outsourcing proposal has, at the minimum, addressed the issues set out in SPM module SA-2 on outsourcing, which include the following areas:</p> <ul style="list-style-type: none"> <li>• outsourcing proposal and/ or draft service agreement;</li> <li>• details of services to be outsourced;</li> <li>• reasons for outsourcing;</li> <li>• details of the service provider if it is not in-house;</li> <li>• risk assessment performed by the AI;</li> <li>• contingency plans in the event of problems.</li> </ul> <p>For outsourcing of critical technology services (e.g., data centre operations), AIs are also required to commission a detailed assessment of the technology service provider's IT control environment.</p> <p>As specified in the template of SCSA TRM, the annual SCSA TRM covers the following areas in respect to technology outsourcing:</p> <ul style="list-style-type: none"> <li>• management of technology outsourcing (e.g., service level agreements, contracts, etc);</li> <li>• continuous monitoring and assessment of performance of outsourced service providers;</li> <li>• contingency planning for outsourcing arrangements.</li> </ul> <p>In discussion with the HKMA, the authority confirmed the importance placed on an AI having contingency arrangements in place. Customer confidentiality, personal data protection and rights of access were topics of particular concern. AIs would be challenged, in cases where customer data was involved in the outsourced arrangements, whether the project was necessary. More broadly, however, the HKMA indicated that provided all appropriate protections were in place, including meeting all</p>
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	<p>requirements set out in SPM SA-2 that their supervisory stance was neutral. The bank has to undertake a self-assessment for outsourcing and it would be typical, especially if the outsourcing were to be outside HKSAR, for the HKMA to seek additional information.</p> <p>In terms of underpinning regulatory requirements, the SPM modules relating to both operational risk and outsourcing (SPM OR-1 and SA-2) set out the HKMA's supervisory approach as well as the major requirements which the HKMA recommends AIs to address when outsourcing their activities. For the management of technology-related outsourcing, AIs should follow SPM module TM-G-1.</p>
<b>Additional criteria</b>	
<b>AC1</b>	The supervisor regularly identifies any common points of exposure to operational risk or potential vulnerability (e.g., outsourcing of key operations by many banks to a common service provider or disruption to outsourcing providers of payment and settlement activities).
<b>Description and findings re AC1</b>	<p>Under the terms of the SPM (OR-1) the HKMA has regard to, among others, the causes and impacts of significant operational risk events of an AI in assessing the AI's operational risk exposure, and requires AIs to notify the HKMA of any event(s) that may have a significant impact on their operations. Information about significant operational events is, among others, used to identify common points of exposure to operational risk.</p> <p>The HKMA identifies and monitors common points of operational risk or potential vulnerabilities through four main channels: (i) the annual SCSA ORM; (ii) on-site examinations of AIs' ORM; (iii) analysis of the causes and impact of AIs' operational events; and (iv) monitoring of latest market and industry developments and AIs' initiatives (e.g., new products or outsourcing).</p> <p>Through the analysis of the types and sources of operational loss data submitted by AIs during the annual SCSA ORM, the ORM team identifies the common points of operational risk or potential vulnerabilities. When handling significant operational events reported by AIs and reviewing the results of on-site examinations, both the ORM team and the supervisory case teams identify whether the root causes of the events or significant examination findings may also have wider impact and affect other AIs. For instance, there was an incident where an AI adopting a particular processing mode for its credit card service reported to the HKMA that it encountered transaction problem for certain dates of transaction. To ascertain if it is an AI-specific problem or a common problem affecting various AIs, the HKMA promptly checked with the service vendor and other AIs using the same processing mode to see if these AIs also experienced similar problem.</p> <p>The ORM team and IT specialist team also identify common sources of operational risk through monitoring of latest industry developments and AIs' initiatives. For instance, once the IT specialist team is aware of a security breach of a security device vendor commonly used by some AIs for their internet banking systems and remote access to the AIs' internal systems, the team assesses the impact of the breach on those AIs and monitors their rectification actions. Separately, some issues about the security</p>

	<p>practices of an IT outsourcing arrangement were identified, the HKMA then adopted a consistent regulatory stance to assess all AIs' proposals to engage such outsourcing arrangement.</p> <p>Further, as a result of the identification and assessment of the operational risk at industry level, the HKMA has issued a number of relevant circulars to address AIs' common points of exposure to potential vulnerability. In particular:</p> <ul style="list-style-type: none"> <li>• to reduce the risk of Internet banking frauds involving fake bank websites and phishing e-mails, the HKMA has required AIs to adopt two-factor authentication for online high-risk transactions (two circulars issued in 2004);</li> <li>• to mitigate the risk of Internet banking frauds involving common Trojan horse programs in 2009, the HKMA has required AIs to further strengthen the security controls for Internet banking services, which included protection of one-time password and sending customers SMS notification immediately after the transaction (2009);</li> <li>• to combat against common ATM frauds, the HKMA has required AIs to implement chip-based ATMs (2011);</li> <li>• to mitigate the risk of customer data leakage due to increasing use of portable storage devices, the HKMA has required AIs to implement control measures in respect to, among others, portable storage devices, mobile computing, and outside service providers (2008).</li> </ul>
<b>Assessment of Principle 25</b>	Compliant
<b>Comments</b>	The HKMA has developed a balanced program for assessing ORM, utilizing on and off-site techniques and applying a risk based approach. Specialist teams for operational risk and technology risk have been created and there is a strong focus on raising awareness and encouraging industry wide good practice, such as through the issuance of circulars.
<b>Principle 26</b>	Internal control and audit. The supervisor determines that banks have adequate internal control frameworks to establish and maintain a properly controlled operating environment for the conduct of their business taking into account their risk profile. These include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent <sup>69</sup> internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require banks to have internal control frameworks that are adequate to establish a properly controlled operating environment for the conduct of their business, taking into account their risk profile. These controls are the

<sup>69</sup> In assessing independence, supervisors give due regard to the control systems designed to avoid conflicts of interest in the performance measurement of staff in the compliance, control and internal audit functions. For example, the remuneration of such staff should be determined independently of the business lines that they oversee.

	<p>responsibility of the bank's Board and/or senior management and deal with organizational structure, accounting policies and processes, checks and balances, and the safeguarding of assets and investments (including measures for the prevention and early detection and reporting of misuse such as fraud, embezzlement, unauthorized trading and computer intrusion). More specifically, these controls address:</p> <ul style="list-style-type: none"> <li>(a) organizational structure: definitions of duties and responsibilities, including clear delegation of authority (e.g., clear loan approval limits), decision-making policies and processes, separation of critical functions (e.g., business origination, payments, reconciliation, risk management, accounting, audit and compliance);</li> <li>(b) accounting policies and processes: reconciliation of accounts, control lists, information for management;</li> <li>(c) checks and balances (or "four eyes principle): segregation of duties, cross-checking, dual control of assets, double signatures; and</li> <li>(d) safeguarding assets and investments: including physical control and computer access.</li> </ul>
<p><b>Description and findings re EC1</b></p>	<p>The BO (Schedule 7 Paragraph 10) provides that the MA must be satisfied that an AI has adequate accounting systems and adequate systems of control and this standard constitutes a minimum authorization criterion that must be met by every AI on a continuing basis. The BO further sets out (Schedule 14) that a manager of an AI is principally responsible for the AI's systems of accounting and internal controls. The HKMA expectations in respect of the internal control framework and environment, including allocation of responsibility to the Board and management are set out extensively in the SPM (notably IC-1).</p> <p>HKMA expectations in relation to organization structure (again largely set out in SPM IC-1) include the requirement that the Board and senior management establish adequate segregation of duties and clear accountability, adopt formal documentation of roles, and ensure independent risk management and control functions as well as formulating detailed policies, procedures and limits. The SPM (IC-1) also sets out accounting and reconciliation requirements, elements of a sound internal controls system, including relating to conflict of interest.</p> <p>The HKMA is in the process of updating SPM IC-2 "Internal Audit Function" to incorporate the enhanced guidance "The internal audit function in banks" issued by the Basel Committee in 2012. In the meantime, in July 2012, the HKMA issued a circular letter "BCBS Revised Guidance on Internal Audit Function in Banks."</p> <p><i>On and off-site examination</i></p> <p>Review of internal controls is a standard item for virtually all on-site examinations, and the scope of the examination will typically cover one or more of the following internal control related scopes (not exhaustive):</p> <ul style="list-style-type: none"> <li>• review of the overall compliance function</li> <li>• review of the internal audit function</li> </ul>

	<ul style="list-style-type: none"> <li>• review of systems of controls in individual business lines: this typically includes performing walk-through exercise to ascertain whether adequate and effective check and balance (or “four-eye principles), physical control, clear delegation of authority, proper organization structure, etc. are in place</li> <li>• review the system of appointment of manager under BO section 72B</li> </ul> <p>The assessors were able to confirm that the scope of on-site examinations paid close attention to the audit, compliance and control systems and environment. Follow-up letters to AIs required remedial action(s) to be completed according to clear timelines.</p> <p>Extensive and comprehensive guidance is provided to the examiners to assess whether AIs satisfy the SPM requirements and/or additional standards. On-site examination will therefore normally include:</p> <ul style="list-style-type: none"> <li>• review of internal policies and procedures as well as other relevant documents (e.g., charter or other form of equivalent written mandate, transaction samples, etc.);</li> <li>• interviews with management and staff to ascertain their familiarity of the relevant regulatory requirements and internal policies and procedures as well as their control awareness; and</li> <li>• performing walk-through exercise to understand the work flows and identify any discrepancy between the actual practice and written procedures, etc.</li> </ul> <p>The off-site review considers documents including management reports submitted to Board and senior management and meeting minutes of the Board or various Board-level and management-level specialized committees. When the off-site review identifies issues of concern, the HKMA can, and has as the assessors were able to confirm, accelerated on-site inspection and required remedial action from executive management in a defined time period. The HKMA will also include the exchange of views with the AI’s external auditors at tripartite meetings, interview with the Board and/or senior management of the AI as part of its overall assessment.</p>
<b>EC2</b>	<p>The supervisor determines that there is an appropriate balance in the skills and resources of the back office, control functions and operational management relative to the business origination units. The supervisor also determines that the staff of the back office and control functions have sufficient expertise and authority within the organization (and, where appropriate, in the case of control functions, sufficient access to the bank’s Board) to be an effective check and balance to the business origination units.</p>
<b>Description and findings re EC2</b>	<p>There are numerous references to the adequacy of controls, competency and sufficiency of staff throughout the SPM (see corporate governance CG-1, general risk management controls IC-1, internal audit IC-2 and competence and ethical behavior CG-6 in particular). Further, the Guideline for Authorization (GTA) reinforces the HKMA’s expectations in relation to adequacy of control functions.</p> <p><i>On and off-site examination</i></p> <p>The process for both on-site examination and off-site surveillance is broadly as set out under EC 1. The HKMA seeks to assess the adequacy of skills, resources, expertise and authorities of these functions in the following ways:</p>

	<ul style="list-style-type: none"> <li>• regularly updated information on staffing of back offices, control functions and operational units. The HKMA also collects information about the work experience and academic qualification of the key personnel.</li> <li>• peer review of the back office, control function resources between AIs.</li> <li>• comparison of staffing levels against AI's budgets.</li> <li>• reviewing audit trails, e.g., status log on follow-up of exceptions and limit breaches, timely escalation of unresolved issues, timeliness and quality of investigation into exceptions etc.</li> <li>• reviewing the organizational chart and other relevant documents (e.g., human resource policies). The HKMA looks to confirm that the staff in charge of control functions (e.g., risk management) should be at least of equivalent rank with those in charge of business origination units and that there is a reporting line independent from the business origination units. In discussion with the HKMA and as confirmed with firms with whom the assessors met, the HKMA places considerable emphasis on ensuring that control functions have status and authority within an organization. When reviewing specialized committees such as the Credit Committee, the HKMA checks to ensure it is not chaired by the head of the business origination unit.</li> <li>• the HKMA pays attention to whether key control functions have unfettered access to the Board and senior management and as part of its checks reviews Board minutes to identify whether control staff have expressed views and whether these views have been taken into consideration by the Board and senior management.</li> </ul> <p>The assessors were able to confirm that this range of inputs was assessed by the HKMA and informed the overall risk assessment of AIs.</p>
<b>EC3</b>	<p>The supervisor determines that banks have an adequately staffed, permanent and independent compliance function<sup>70</sup> that assists senior management in managing effectively the compliance risks faced by the bank. The supervisor determines that staff within the compliance function is suitably trained, have relevant experience and have sufficient authority within the bank to perform their role effectively. The supervisor determines that the bank's Board exercises oversight of the management of the compliance function.</p>
<b>Description and findings re EC3</b>	<p>Guidance on an AI's compliance function, including sufficiency, competence, independence and requirements regarding Board oversight is provided in SPM IC-1. The SPM module on Internal Audit Function (IC-2) lays down the main responsibilities of the compliance function of an AI and requires the compliance function to be separate from, and subject to the independent review of, the internal audit function. Compliance standards are further reinforced through the SPM on Reputation Risk Management (RR-1).</p> <p><i>On and off-site examination</i></p>

<sup>70</sup> The term "compliance function" does not necessarily denote an organizational unit. Compliance staff may reside in operating business units or local subsidiaries and report up to operating business line management or local management, provided such staff also have a reporting line through to the head of compliance who should be independent from business lines.

	<p>In assessing the compliance function, for the key areas on which the HKMA seeks to focus are: board and senior management oversight; policies governing AIs' compliance with laws and other regulatory requirements (including prudential limits); compliance monitoring; MIS and internal audit on compliance function.</p> <p>The HKMA seeks to have regular contact with the AIs' compliance function, senior management, Board or Board-level Committees (e.g., Risk Management and Compliance Committee or Audit Committee), and group head of compliance when the AI is a part of the foreign bank group as well as contact with the relevant overseas banking supervisory authorities.</p> <p>The general practices adopted in reviewing the compliance functions mirror the approaches set out in ECs1 and 2 and are noted below:</p> <ul style="list-style-type: none"> <li>• review of the information pack submitted to the Board, Board-level committee (e.g., Risk Management and Compliance Committee or Audit Committee) as well as minutes of the meetings. This review is supplemented by regular meetings with the Board or Committees.</li> <li>• review of Board and relevant committee minutes, supplemented by meetings with members of Board and senior committee, not only to confirm the quality of understanding but to enhance insight into overall risk culture of an AI.</li> <li>• review of organization chart where the HKMA seeks to confirm that the compliance unit has independent reporting line to the senior management (in particular, the chief executive) and the Board and/or Board level committees.</li> <li>• review of charter or mandate as well as sampling of documents and correspondence.</li> <li>• review of the work of compliance function (e.g., the compliance plan, test programs and reports). The HKMA pays particular attention to exceptions noted in the compliance work and whether there have been any issues raised by other supervisors. Slippage in completion of the compliance work plan is noted and discussed.</li> <li>• peer review of compliance resources with other AIs.</li> <li>• review of qualifications and continuing training of compliance staff.</li> </ul> <p>The assessors were able to confirm that the HKMA undertook the review of Board oversight, conducted its own reviews and that regulatory intervention took place when concerns arose in relation to compliance functions.</p>
<b>EC4</b>	<p>The supervisor determines that banks have an independent, permanent and effective internal audit function<sup>71</sup> charged with:</p> <ol style="list-style-type: none"> <li>(a) assessing whether existing policies, processes and internal controls (including risk management, compliance and corporate governance processes) are effective, appropriate and remain sufficient for the bank's business; and</li> <li>(b) ensuring that policies and processes are complied with.</li> </ol>

<sup>71</sup> The term "internal audit function" does not necessarily denote an organizational unit. Some countries allow small banks to implement a system of independent reviews, e.g., conducted by external experts, of key internal controls as an alternative.



<p><b>Description and findings re EC4</b></p>	<p>The requirements for the internal audit function are set out primarily in the SPM IC-2. Further, the SPM module on General Risk Management Controls (IC-1) requires an internal audit function to carry out independent periodic checking on whether the risk management framework approved by the Board is properly implemented and the established policies and control procedures in respect of risk management are complied with.</p> <p>As noted above, at the time of the assessment, the HKMA was in the process of updating this SPM module to incorporate the enhanced guidance “The internal audit function in banks” issued by the Basel Committee in 2012, but in the interim had, in July 2012, issued a circular letter to AIs to address this guidance.</p> <p>In the context of the SPM, the HKMA has particular regard to sufficiency of resources, independence, authority, status and reporting lines, unfettered access to any member of staff and records, application of methodology to identify material risks and authority to assess outsourced functions.</p> <p>In assessing the effectiveness of the internal audit function, the HKMA carries out documentary review of their work during off-site reviews; on-site examinations, and direct contact with the internal audit function, senior management, Board or Audit Committee, external auditors, and, as appropriate, group compliance officers and overseas banking supervisory authorities.</p> <p>Documentary review typically covers and seeks to confirm the following:</p> <ul style="list-style-type: none"> <li>• Independence and authority: organization chart as well as associated information on the structure and functions of the internal audit function;</li> <li>• Expertise, resources and staff management: by assessing membership of the Audit Committee of locally incorporated AIs and discussing with home regulators of foreign bank branches operating in HKSAR to understand their assessment and views on the membership of the audit committees of the foreign banks at the bank/head office level; qualifications and experience of the internal auditors; and frequency and rotational plan.</li> <li>• Authority and documentation of policy and procedures: assessed through audit charter or other form of equivalent written mandate and internal audit policies and manual.</li> <li>• Appropriateness of audit coverage and implementation of audit recommendations: assessed via audit plan; internal audit program, working papers and internal audit reports over a 12 months period and management responses to recommendations and follow-up actions; current progress of work and reasons for deviations from the audit plan, if any.</li> <li>• Quality assurance: assessed through letters or reports from external auditors or other supervisory authorities and as appropriate reports made by the group internal audit function; and minutes of meetings of the Audit Committee.</li> </ul> <p>On-site activity seeks to review and confirm the following areas:</p>
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	<ul style="list-style-type: none"> <li>• Audit Committee: clear definition of authorities and duties and terms of reference of the Audit Committee; frequency and attendance of meetings; reporting of key issues by the Audit Committee to the Board; approval and removal of chief internal auditor by the Board or the Audit Committee;</li> <li>• Internal audit function: access to Board or the Audit Committee as well as departments; adequacy of risk assessment, audit cycle, audit coverage and audit program; quality and follow-up of internal audit; and training.</li> </ul>
<b>EC5</b>	<p>The supervisor determines that the internal audit function:</p> <ol style="list-style-type: none"> <li>has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing;</li> <li>has appropriate independence with reporting lines to the bank's Board or to an audit committee of the Board, and has status within the bank to ensure that senior management reacts to and acts upon its recommendations;</li> <li>is kept informed in a timely manner of any material changes made to the bank's risk management strategy, policies or processes;</li> <li>has full access to and communication with any member of staff as well as full access to records, files or data of the bank and its affiliates, whenever relevant to the performance of its duties;</li> <li>employs a methodology that identifies the material risks run by the bank;</li> <li>prepares an audit plan, which is reviewed regularly, based on its own risk assessment and allocates its resources accordingly; and</li> <li>has the authority to assess any outsourced functions.</li> </ol>
<b>Description and findings re EC5</b>	<p>Please note also EC4 which covers some of the issues raised in this EC.</p> <p>As noted above, the main requirements in relation to internal audit are set out in the SPM (IC-2 and IC-1) and these modules specifically address all the elements of this EC. In its assessment of AIs, the HKMA pays particular regard to (a) appropriate independence and authority to ensure that the senior management acts upon the IAF's recommendations adequately and (b) authority to assess any outsourced functions (where control procedures and internal audit review are also specified in the SPM module on outsourcing - SA-2):</p> <ul style="list-style-type: none"> <li>• Adequacy of staff resources, training and experience of internal auditors: The HKMA reviews the staffing resources, including through peer reviews, and assesses whether any slippages in the internal audit plan are due to insufficiency or lack of training or competence of staffing. Training plans and records are also reviewed.</li> <li>• Independence and authority of internal audit function: The HKMA reviews the organization chart and reporting lines, charter for the internal audit function and samples documentation and correspondence. Board and Audit Committee minutes are reviewed and contact made with Board and senior management to assess the importance attached to internal audit.</li> <li>• Timely information on any material changes: The HKMA considers any material changes made to the bank's risk management strategy, policies or processes and ascertains any involvement of the internal audit function.</li> </ul>

	<ul style="list-style-type: none"> <li>• Access: The HKMA samples documents and correspondence.</li> <li>• Methodology: The HKMA assesses the effectiveness of methodology adopted by AIs for identifying and measuring the risks run by the audited units.</li> <li>• Audit plan: The HKMA evaluates the robustness of the risk assessment by the internal audit function in determining its audit plan, and whether the results of the assessment have been factored into the audit plan. In addition the HKMA checks to ensure the audit plan has been subject to review and approval by the appropriate authority (e.g., Audit Committee).</li> <li>• Outsourcing: The HKMA reviews the service level agreements and may review records to check internal auditors have in practice assessed the outsourced functions.</li> </ul> <p>The HKMA will, on occasion, require the internal audit function of the AIs to perform exercises as part of thematic reviews. AIs with whom the assessors met confirmed that the feedback following such exercises was reflective and helpful. AIs would be informed whether they had performed satisfactorily, required some amendments or whether the findings caused the HKMA to commission an external audit report to assess the internal controls.</p>
<b>Assessment of Principle 26</b>	Compliant
<b>Comments</b>	The HKMA's supervisory practices pay close attention to the adequacy of internal risk control and compliance functions within firms. Off-site techniques complement regular direct contact with Audit Committees and other control functions.
<b>Principle 27</b>	Financial reporting and external audit. The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function.
<b>Essential criteria</b>	
<b>EC1</b>	The supervisor <sup>72</sup> holds the bank's Board and management responsible for ensuring that financial statements are prepared in accordance with accounting policies and practices that are widely accepted internationally and that these are supported by recordkeeping systems in order to produce adequate and reliable data.
<b>Description and findings re EC1</b>	<p>AIs' accounts are prepared based on the HKFRS and audited according to the HKSA's. The HKFRS are in line with the IFRS issued by the IASB<sup>73</sup> whilst the HKSA's are based on the ISA issued by the International Auditing and Assurance Standards Board.</p> <p>Board and management responsibilities are contained not only in the SPM but also the CO (establishes audit requirements) and the BO (section 59(1) requires every AI and its</p>

<sup>72</sup> In this Essential Criterion, the supervisor is not necessarily limited to the banking supervisor. The responsibility for ensuring that financial statements are prepared in accordance with accounting policies and practices may also be vested with securities and market supervisors.

<sup>73</sup> HKFRS have been fully converged with the IFRS from January 1, 2005.

	<p>auditors to comply with the CO with respect to the audit of a company's accounts, whether or not the AI is incorporated under the CO).</p> <p>The CO requires firms, including AIs, to keep proper books of account as well as requiring such accounts to give a true and fair view of the company (and its subsidiaries, if applicable) (sections 121, 123, and 126). Failures by the directors to fulfill their responsibilities, including failure to ensure that the statement of accounts is laid before the annual general meeting of the company, are an offence for which directors are liable to fines and imprisonment. Moreover, adequacy of accounting and control systems is linked to the authorization criteria for AIs.</p> <p>The HKMA reviews directors' responsibility for the financial statements and also the external auditor's opinion on the financial statements. Generally the HKMA requires AIs to provide a copy of the external auditors' management letters for review. The HKMA will also use annual tripartite meetings with AIs and their external auditors to discuss issues identified by the external auditors during the annual audits. However, both the HKMA and firms indicated that a tripartite meeting has not always been held if it has been considered that matters for discussion are not sufficiently significant. Nonetheless, firms confirmed that there has been a marked new emphasis on the tripartite process over the past year.</p> <p>In the course of reviewing certain areas like loan classification, provisioning, valuation during on-site examinations, the HKMA also reviews the relevant record keeping systems of AIs if considered necessary.</p> <p>The HKMA indicated that it maintained contact with the internal auditors and Audit Committee largely on a risk basis but for the systemic firms this would mean at least an annual meeting with the Audit Committee, a practice that the assessors were able to confirm in discussion with the AIs they met.</p>
<b>EC2</b>	The supervisor holds the bank's Board and management responsible for ensuring that the financial statements issued annually to the public bear an independent external auditor's opinion as a result of an audit conducted in accordance with internationally accepted auditing practices and standards.
<b>Description and findings re EC2</b>	<p>As noted under EC1, the BO (section 59(1)) requires all AIs and their auditors to comply with the CO with respect to the audit of a company's accounts, whether or not the AI is incorporated under the CO. The annual financial statements of AIs are prepared based on the HKFRS and audited by external auditors according to the HKSA's which are based on the ISA issued by the International Auditing and Assurance Standards Board.</p> <p>AIs submit copies of the financial statements to the HKMA for review before they are issued to the public. The HKMA reviews the external auditor's opinion (contained in the report of the external auditor) to see whether the financial statements give a true and fair view of the financial position of an AI in accordance with the applicable standards and whether there is any adverse opinion expressed by the external auditor.</p>
<b>EC3</b>	The supervisor determines that banks use valuation practices consistent with accounting standards widely accepted internationally. The supervisor also determines that the framework, structure and processes for fair value estimation are subject to

	independent verification and validation, and that banks document any significant differences between the valuations used for financial reporting purposes and for regulatory purposes.
<b>Description and findings re EC3</b>	<p>AIs incorporated in HKSAR are required to follow HKAS 39, which establishes principles for the recognition and measurement of financial instruments. It is complemented by HKFRS 7 which sets out the disclosure requirements of financial instruments. HKFRS 13, which took effect on 1 January 2013, specifically defines fair value and requires comprehensive disclosures about fair value measurement. HKFRS is in line with IFRS.</p> <p>In addition, locally incorporated AIs must follow the accounting standards established by the HKICPA (which are generally in line with international accounting standards) in preparing the financial accounts, which are subject to external auditors' annual audit for compliance.</p> <p>The SPM on Financial Instrument Fair Value Practices (CA-S-10) further clarifies the HKMA expectations in respect of the governance, control and risk management systems of AIs for the valuation of financial instruments measured at fair value. The SPM module applies to both banking and trading books and reflects relevant guidance issued by the Basel Committee (including the enhanced prudent valuation guidance issued under Basel 2.5) as well as relevant international and local accounting and auditing standards.</p> <p><i>Valuation adjustments</i></p> <p>While AIs are not required to change their valuation practices for financial reporting purposes, they are required to consider appropriate valuation adjustments to meet the prudential objectives of regulatory capital.</p> <p>In respect of valuation adjustments where the application of SPM CA-S-10 leads to a lower carrying value than actually recognized in the accounts, the absolute value of the difference must be deducted from CET1 capital. AIs are also required to establish and maintain procedures for judging the necessity for, and calculating, an adjustment to the current valuation of less liquid positions or complex products for regulatory capital purposes. Any such adjustment must be reflected in an impact on CET1 capital – a figure that the HKMA monitors closely.</p> <p><i>On and off-site examination</i></p> <p>As part of its off-site surveillance, the HKMA generally adopts the following practices:</p> <ul style="list-style-type: none"> <li>• reviewing the financial statements / disclosures;</li> <li>• reviewing the external auditors' reports on financial statements, the management letters issued by the external auditors, and other external auditors' reports commissioned under BO; and</li> <li>• discussion at tripartite meetings with the AIs and their external auditors.</li> </ul> <p>If any material valuation adjustment which is reported by an AI as a deductible item from the CET1 in the banking returns, the HKMA follows up with the AI for the adjustment basis and policies. In practice, there have been no cases of significant difference in reporting between those for accounting reporting purposes and those for</p>

	regulatory reporting purposes. Instances where valuation policies, practices and procedures are subject to more specialized review in on-site examinations include reviews of AIs' treasury and derivatives activities and assessments of implementation of internal model approaches for calculating market risk capital charges. The HKMA has also conducted an examination on distressed debt activity of an AI including a focus on the valuation processes.
<b>EC4</b>	Laws or regulations set, or the supervisor has the power to establish the scope of external audits of banks and the standards to be followed in performing such audits. These require the use of a risk and materiality based approach in planning and performing the external audit.
<b>Description and findings re EC4</b>	<p>The CO primarily governs the external audit of financial statements of AIs. BO section 59(1) provides that every AI, and its auditors, shall comply with the CO with respect to the audit of a company's accounts, whether or not the AI is incorporated under the CO.</p> <p>The scope of the audits should be determined, and the audits should be conducted, according to the HKSA's issued by the HKICPA. The HKSA's are based on the ISA issued by the International Auditing and Assurance Standards Board. Under these standards, the auditors are required to comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements as a whole are free from material misstatement. The concept of materiality is applied by the auditors both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. (HKSA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with HKSA" Paragraphs 5 and 6).</p> <p>The HKMA reviews the external auditors' reports on financial statements and management letters issued by the external auditors to see if there is any adverse opinion made or issue identified by the external auditors when they conduct the annual audits. The HKMA may discuss these issues at the tripartite meetings with the AIs and their external auditors. As noted above, these meetings have not always taken place if the issues did not appear to warrant particular discussion.</p>
<b>EC5</b>	Supervisory guidelines or local auditing standards determine that audits cover areas such as the loan portfolio, loan loss provisions, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitizations, consolidation of and other involvement with off-balance sheet vehicles and the adequacy of internal controls over financial reporting.
<b>Description and findings re EC5</b>	<p>The scope of audit of an AI's financial statements is determined by the AI's external auditor in accordance with the relevant auditing standards issued by HKICPA (the standards are included in the HKICPA Members' Handbook). As the HKSA's are based on the ISA, the areas required under this criterion are covered by the audit scope.</p> <p>As noted under EC4, the HKMA reviews the management letters issued by external auditors to AIs and uses tripartite meetings with AIs and their external auditors to discuss matters relating to audit scope if necessary.</p>

<b>EC6</b>	The supervisor has the 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.
<b>Description and findings re EC6</b>	<p>The HKMA does not have the specific direct power to reject or rescind the appointment of an external auditor. Appointment and removal of an auditor is governed by the CO.</p> <p>Nevertheless, the HKMA has the power to commission specific prudential audits and reports under BO sections 59(2), 63(3) and 63(3A). The HKMA requires the AI to appoint an auditor approved by the HKMA for these purposes. Additionally, the conduct of an external audit by an auditor who is deemed to have inadequate experience, competence or independence, might trigger the MA's formal powers under section 52 (after consultation with the FS). In the first instance the HKMA would discuss its concerns with the AI and it would be unusual for the AI not to respond appropriately given the potential for more severe measures. The HKMA discussed situations that had arisen when there had been concerns with respect to the appointment of the auditor but as a result of HKMA intervention the situation had been resolved to the satisfaction of the HKMA.</p>
<b>EC7</b>	The supervisor determines that banks rotate their external auditors (either the firm or individuals within the firm) from time to time.
<b>Description and findings re EC7</b>	The Code of Ethics for Professional Accountants of the HKICPA requires mandatory rotation of the engagement partner for listed companies and other public interest entities after a pre-defined period, normally no more than 7 years. This expectation is further underpinned by the SPM module on Corporate Governance of Locally Incorporated Authorized Institutions (CG-1). The HKMA is planning to conduct a thematic review on AIs' implementation of the above requirement in the near future.
<b>EC8</b>	The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.
<b>Description and findings re EC8</b>	<p>The SPM module on Corporate Governance (CG-1) confirms that the HKMA will communicate with an AI's external auditors on a regular basis. The module on Reporting Requirements (SPM IC-3) further confirms that tripartite meetings can be called by any of the parties and convened at any time.</p> <p>In practice, tripartite meetings between the AI, the HKMA and the external auditors are typically held annually for locally incorporated AIs. The HKMA also maintains regular dialogue with the audit profession via the HKICPA's Banking Regulatory Liaison Group (comprising representatives from major audit firms) to discuss issues of common interest. These include accounting developments and their implications for AIs, key supervisory policy developments domestically and internationally, and bank operations (as appropriate).</p>
<b>EC9</b>	The supervisor requires the external auditor, directly or through the bank, to report to the supervisor matters of material significance, for example failure to comply with the licensing criteria or breaches of banking or other laws, significant deficiencies and control weaknesses in the bank's financial reporting process or other matters that they believe are likely to be of material significance to the functions of the supervisor. Laws

	or regulations provide that auditors who make any such reports in good faith cannot be held liable for breach of a duty of confidentiality.
<b>Description and findings re EC9</b>	<p>The external auditor of an AI is required under the BO (section 63A) to report to the MA if during the course of an audit the auditor becomes aware of a matter which in his opinion adversely affects the financial position of an AI to a material extent. The audit may be the annual audit carried out under the CO (section 141) or the BO (specially commissioned audits and reports under sections 59(2), 63(3) and 63(3A)).</p> <p>Where the AI is also a registered institution under the SFO, the auditor is also required to report any matter uncovered in an audit that in its opinion constitutes a failure on the part of the institution to comply with “prescribed requirements” (within the meaning of the SFO section 157).</p> <p>Additionally, the BO (section 59A(2)(c)) requires the external auditor appointed under section 131 of the CO to immediately report any qualification to the accounts or adverse statement as to a matter mentioned in CO section 141 (i.e. relating to the auditor’s report).</p> <p>Statutory protection (BO section 61) is provided to an auditor of an AI who communicates in good faith to the MA contrary to any duty he may be subject to, whether or not in response to a request made by the MA, any information or opinion on a matter of which he becomes aware in his capacity as auditor and which is relevant to any function of the MA under the BO (see also SPM IC-3).</p>
<b>Additional criteria</b>	
<b>AC1</b>	The supervisor has the power to access external auditors’ working papers, where necessary.
<b>Description and findings re AC1</b>	<p>The MA does not have the direct power to access external auditors’ working papers. However, under BO section 117, if it appears to the MA that it is in the interests of depositors of an AI or a former AI or in the public interest to carry out an investigation of the AI, the MA may make a report to the FS who may appoint an inspector to conduct the investigation. BO section 118(3) stipulates that it shall be the duty of every director, manager, employee or agent of an AI whose affairs, business and property is under investigation (whether by virtue of BO section 117(2) or section 118(2)) and any person who has in his possession books, papers or information relevant to the investigation (which could include the AI’s auditor) to produce to the inspector all books and papers relating to the AI which are in his custody or power.</p> <p>Additionally, under Section 25 of the FRC Ordinance (Cap. 588) the FRC has powers to obtain audit working papers for the purpose of its investigation into auditing irregularities in relation to listed entities. The FRC has powers to assist the HKMA when the latter is investigating, enquiring into or dealing with a case or complaint concerning a listed AI (section 12) and may disclose information it obtains to the HKMA if the FRC is of the view that the disclosure will enable or assist HKMA to perform its function and it is not contrary to the interest of the investing public or public interest (section 51). An MoU was signed in 2007 setting out the framework for cooperation and communication pursuant to investigations and enquiries conducted by FRC in relation to listed AIs. Gateways therefore exist that can provide the HKMA</p>



	with the external auditors' working papers, provided that the FRC has itself requested such papers and agrees that communicating them to the HKMA is consistent with its own legal obligations.
<b>Assessment of Principle 27</b>	Largely Compliant
<b>Comments</b>	<p>The HKMA devotes effort to ensuring effective communication channels with the external auditors. Furthermore, the HKMA's use of its powers to commission reports on AIs to be carried out by the external auditors for supervisory purposes (this is an annual exercise for all AIs) further supports the nature of the relationship and the understanding of the HKMA's supervisory concerns.</p> <p>However, there are two areas in which the HKMA lacks powers and where the legislative framework could therefore be enhanced, even though the HKMA has, to date, been able to address issues that have arisen by indirect means. First, 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. Secondly, it is recommended that the supervisor is granted the direct power to access external auditors' working papers, where necessary.</p>
<b>Principle 28</b>	Disclosure and transparency. The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes.
<b>Essential criteria</b>	
<b>EC1</b>	Laws, regulations or the supervisor require periodic public disclosures <sup>74</sup> of information by banks on a consolidated and, where appropriate, solo basis that adequately reflect the bank's true financial condition and performance, and adhere to standards promoting comparability, relevance, reliability and timeliness of the information disclosed.
<b>Description and findings re EC1</b>	<p>The BO and CO provide the framework for the disclosure of financial information. At a general level, the authorization criteria set out in the BO (Schedule 7) require a locally incorporated AI to disclose adequate information. More specifically, the BO (section 60) requires AIs incorporated in HKSAR to exhibit, no later than four months after the close of each financial year, a copy of its audited annual accounts for that year, a copy of the report of the auditors made pursuant to CO section 141 and a copy of the report of the directors laid or to be laid before the company in general meeting.</p> <p>A foreign branch in HKSAR must lodge, no later than six months after the close of each financial year, a copy of its audited annual balance sheet and a copy of the profit and loss account, a copy of the auditor's report and a copy of the directors' report where such report is required in the place where the AI is incorporated.</p> <p>The CO further requires (section 141) that the auditors examine the accounts of the</p>

<sup>74</sup> For the purposes of this Essential Criterion, the disclosure requirement may be found in applicable accounting, stock exchange listing, or other similar rules, instead of or in addition to directives issued by the supervisor.

	<p>company and report to the shareholders on whether, in their opinion, the accounts give a true and fair view of the company's financial position and have been prepared in accordance with the provisions of the CO, which requires the financial statements to present a true and fair view (section 123).</p> <p>In respect of comparability and relevance, the Banking Disclosure Rules (BDR) which are legally binding and are made by the HKMA under the BO, contain a range of requirements including:</p> <ul style="list-style-type: none"> <li>• Specification of the financial risk information which is based on the current standards for Pillar 3 disclosure under the Basel capital adequacy framework (including Basel 2, Basel 2.5) as well as requirements under the relevant financial reporting standards in Hong Kong</li> <li>• Standard disclosure templates</li> <li>• Senior management responsibility to disclose all relevant information</li> </ul> <p>Reliability: The BDR further requires the senior management to ensure that the information disclosed is scrutinized and subject to an internal review in order to ensure that the information is not false or misleading in any material respect.</p> <p>Consolidated group level disclosures: the BDR requires disclosures to be made on the same basis as required for the calculation of the CAR although the AI may make additional solo or consolidated disclosure in the interests of greater clarity of understanding.</p> <p>Frequency and timeliness of disclosure: the BDR requires disclosure to be on a semi-annual basis unless an AI is exempted under de minimis provisions.</p> <p>The disclosure statements, according to the BDR, have to be published within the following time limits:</p> <p>For locally incorporated AIs:</p> <ul style="list-style-type: none"> <li>• Annual financial disclosure – not later than 4 months after the end of the reporting period.</li> <li>• Interim financial disclosure – not later than 3 months after the end of the reporting period</li> </ul> <p>For foreign branches in HKSAR:</p> <ul style="list-style-type: none"> <li>• Both annual and interim financial disclosures – not later than 3 months after the end of the reporting period.</li> </ul> <p>Separately, all AIs that are listed in the Main Board of the Stock Exchange of HKSAR, irrespective of their place of incorporation (i.e. foreign branches and local subsidiaries), are subject to the CO and the Listing Rules in publishing their financial information.</p>
<b>EC2</b>	The supervisor determines that the required disclosures include both qualitative and quantitative information on a bank's financial performance, financial position, risk

	<p>management strategies and practices, risk exposures, aggregate exposures to related parties, transactions with related parties, accounting policies, and basic business, management, governance and remuneration. The scope and content of information provided and the level of disaggregation and detail is commensurate with the risk profile and systemic importance of the bank.</p>
<b>Description and findings re EC2</b>	<p>The scope of information required under HKFRS includes qualitative and quantitative disclosure requirements on a bank's financial performance and position. Further, the Banking Disclosure Rules (BDR) were developed based on the disclosure requirements under Pillar 3 of Basel which encompass qualitative and quantitative information on a bank's risk management strategies and practices, risk exposures and basic business, management, governance and remuneration.</p> <p>AIs are required under the BDR to lodge a copy of their disclosure statement prior to publication. The HKMA reviews the statements to ensure:</p> <ul style="list-style-type: none"> <li>• Compliance with the BDR;             <ul style="list-style-type: none"> <li>• Reconciliation with the relevant banking returns and for any material differences to be accounted for; and</li> <li>• Proportionality of the scope and contents of information provided, as well as the level of disaggregation and detail, to the sophistication of the approach (and models) used for the measurement of credit risk.</li> </ul> </li> </ul> <p>The disclosures required under the BDR are minimum standards. The HKMA encourages AIs to make more extensive voluntary disclosures where it is practical for them to do so. There were some enhanced disclosures made by the industry relating to MBS holdings after the crisis emerged in 2008. The HKMA indicated that it encouraged firms to disclose more than was legally required, particularly in relation to non-bank exposures to Mainland China.</p>
<b>EC3</b>	<p>Laws, regulations or the supervisor require banks to disclose all material entities in the group structure.</p>
<b>Description and findings re EC3</b>	<p>Under BDR section 18 and 33, locally incorporated AIs are required to disclose a list of all subsidiaries (covering both accounting and regulatory consolidation) together with a description of the principal activities, the amount of total assets and the amount of total equity reported on the financial statements of each of such subsidiary.</p> <p>Separately, to comply with HKFRS, an AI must disclose any joint arrangements and associates. HKFRS 12 "Disclosure of Interests in Other Entities" is a consolidated disclosure standard requiring a wide range of disclosures about an entity's interests in subsidiaries, joint arrangements, associates and unconsolidated "structured entities." However, an AI is not required to disclose its parent company (i.e. parent company of the legal entity of which it is a branch) or sister companies.</p> <p>There are only two cases where a local AI, together with other sister companies, are headed by an ultimate holding company that is neither supervised by the MA nor an overseas banking regulator and where, therefore, overall group disclosures may be deficient. In these instances, BDR disclosure requirements on related party transactions would expose these relationships if the transactions are material.</p>
<b>EC4</b>	<p>The supervisor or another government agency effectively reviews and enforces</p>

	compliance with disclosure standards.
<b>Description and findings re EC4</b>	<p>The HKMA reviews the disclosure statements submitted by an AI, for compliance with the disclosures requirements set out in the BDR. AIs are also required to indicate their compliance with the BDR along with confirmation of any contravention of other provisions in the BO currently reported to the HKMA via submission of the Certificate of Compliance return on a quarterly basis. The HKMA checks AIs' declaration of their compliance in the return and follows up with AIs which declare non-compliance, if any, in the return.</p> <p>Non-compliance is viewed gravely by the HKMA who have, inter alia, used the supervisory review process to engage with the AI, as the assessors were able to verify through file review. Failure to comply with requirements under the BDR constitutes an offence under the BO. Similarly, failure to disclose adequate information is also a violation of the criteria for continued authorization under the BO and can lead to fines, imprisonment and potentially revocation of authorization.</p>
<b>EC5</b>	The supervisor or other relevant bodies regularly publishes information on the banking system in aggregate to facilitate public understanding of the banking system and the exercise of market discipline. Such information includes aggregate data on balance sheet indicators and statistical parameters that reflect the principal aspects of banks' operations (balance sheet structure, capital ratios, income earning capacity, and risk profiles).
<b>Description and findings re EC5</b>	<p>The MA may prepare and publish aggregate information of AIs under the BO (sections 63 and 120). HKMA publications, available on the HKMA's website, provide aggregate information on the banking system on a regular basis include:</p> <ul style="list-style-type: none"> <li>• Monthly Statistical Bulletin, covering a wide range of banking related statistics and trends, and other monetary and financial indicators.</li> <li>• Quarterly Bulletin, containing a regular article analyzing developments of the banking sector (e.g., interest rate trends, profitability, CAR, asset quality and movements of the major balance sheet items).</li> <li>• Half-Yearly Monetary and Financial Stability Report, analyzing in detail the recent external and domestic influences (including developments of the domestic banking sector) on Hong Kong's monetary and financial systems.</li> </ul> <p>The HKMA also regularly discloses results of surveys conducted to enhance market transparency of the performance of the banking sector's major activities and consumer credit portfolios. These surveys include residential mortgage lending, credit cards, selected debt securities, and derivatives and securitization activities.</p>
<b>Additional criteria</b>	
<b>AC1</b>	The disclosure requirements imposed promote disclosure of information that will help in understanding a bank's risk exposures during a financial reporting period, for example on average exposures or turnover during the reporting period.
<b>Description and findings re AC1</b>	The BDR, which reflects the prevailing Basel 3 expectations, prescribes the minimum disclosure requirements for AIs, which include disclosures on objectives and policies of risk management for each type of risk (capital adequacy, credit risk, liquidity risk, market risk, operational risk, interest rate risk in the banking book, equities). Illustrative disclosures include:

	<ul style="list-style-type: none"> <li>• definition of capital and CARs;</li> <li>• average liquidity ratio for the interim (or annual) reporting period;</li> <li>• average, high and low value-at-risk (VaR) for the annual reporting period and VaR as at the last trading day;</li> <li>• average, high and low stressed VaR for the annual reporting period and stressed VaR as at the last trading day;</li> </ul> <p>The HKMA indicated that following the implementation of Basel 2 and 2.5 it had undertaken a review of disclosures and had again reviewed disclosures to ensure AIs were meeting Basel 3 standards. The HKMA will consider the need to provide further guidance if its review indicates that further guidance would be helpful to ensure consistency.</p>
<b>Assessment of Principle 28</b>	Compliant
<b>Comments</b>	<p>The HKMA has implemented all Pillar 3 requirements in a timely manner through the Banking (Disclosure) Rules and has promoted the recommendations of the FSB's Enhanced Disclosure Task Force to the local market through its dialogue with the Hong Kong Association of Banks. The HKMA is also monitoring actual practice and is sensitive to the possible need to provide additional guidance to the AIs to ensure effective disclosure.</p> <p>While compliant with the principle, as a regulator of a major international financial center, the HKMA is not at the forefront of transparency and disclosure practices relative to leading regulators of advanced jurisdictions, meaning that the HKMA could itself provide greater disclosure of financial and risk data. The HKMA may therefore wish to consider, as much as the duty of confidentiality allows, the public disclosure of HKMA supervisory returns and information on procedures that have informed supervisory decisions. Transparency in supervisory returns and decision-making procedures not only acts as a limit on any potential for arbitrary decision making, it can help support the overall independence of the supervisory authority itself. Some other regulators publish substantially more information including in time series format on bank performance and risk indicators at the aggregate and individual institution level. All major international financial firms will be subject to such levels of disclosure in one or more of the jurisdictions in which they are active.</p>
<b>Principle 29</b>	Abuse of financial services. The supervisor determines that banks have adequate policies and processes, including strict customer due diligence (CDD) rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities. <sup>75</sup>
<b>Essential criteria</b>	
<b>EC1</b>	Laws or regulations establish the duties, responsibilities and powers of the supervisor

<sup>75</sup> The Committee is aware that, in some jurisdictions, other authorities, such as a financial intelligence unit (FIU), rather than a banking supervisor, may have primary responsibility for assessing compliance with laws and regulations regarding criminal activities in banks, such as fraud, money laundering and the financing of terrorism. Thus, in the context of this Principle, "the supervisor" might refer to such other authorities, in particular in Essential Criteria 7, 8 and 10. In such jurisdictions, the banking supervisor cooperates with such authorities to achieve adherence with the criteria mentioned in this Principle.

	related to the supervision of banks' internal controls and enforcement of the relevant laws and regulations regarding criminal activities.
<b>Description and findings re EC1</b>	<p>The Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (AMLO), which came into force in April 2012, (a) provides statutory backing for requirements relating to customer due diligence and record keeping in relation to specified financial institutions; (b) provides for the powers of relevant authorities (RA, including the MA) to supervise compliance with those requirements and other requirements under AMLO; (c) establishes a review tribunal to review certain decisions made by RAs (including the MA) under the AMLO; and (d) provides for incidental and related matters.</p> <p>Under the AMLO, the MA has a full range of powers of supervision and investigation to determine compliance with legal and regulatory requirements. The MA may also, under the AMLO, initiate investigations if he has reasonable cause to believe that an offence under AMLO may have been committed or has reason to inquire whether an AI has contravened a specified provision. Investigators are empowered under the AMLO to require the person under investigation or those believed to be in possession of relevant documents/information possessors to produce documents and/or attend before the investigator to answer questions. Investigators can also obtain search warrants to enter premises and search for, seize and remove documents under the AMLO.</p> <p>More broadly, Schedule 7 of the BO establishes that adequate internal controls are a condition of continuing authorization. In addition the BO provides gateways for the disclosure of information by the MA, including to the police or the Independent Commission Against Corruption (ICAC) at the request of the Secretary for Justice where the information is relevant to the investigation of a criminal complaint. The police may also obtain a warrant from a magistrate under the BO to enter and search any premises when there is reasonable ground for suspecting that an offence under the BO has been committed.</p> <p>Under the AMLO section 7(1), a relevant authority including the MA may publish any guideline that it considers appropriate in relation to customer due diligence (CDD) and record-keeping requirements. The AML Guideline, which is also published under BO section 7(3), came into operation on 1 April 2012 providing guidance on AML/CFT controls, including CDD and record-keeping measures.</p> <p>The AMLO and the AML Guideline seek to address deficiencies identified in the 2008 Mutual Evaluation of HKSAR. The AMLO, as an Ordinance, is directly enforceable (see EC8). While a failure to comply with the guideline does not by itself render the person liable to any judicial or other proceedings, the guideline is admissible and can ultimately be taken into account in any proceedings under the AMLO before any court. As with the SPM in relation to the BO, the Guidelines express the HKMA's expectations of what is required for an AI to meet the terms of the AMLO.</p> <p>The MA has also issued the Guideline on Exercising Power to Impose Pecuniary Penalty which set out the factors that the MA would normally consider in determining whether to impose a pecuniary penalty on an AI and the amount of the penalty.</p>

	<p>In order to assess the internal controls and compliance with the BO (Schedule 7) and the AMLO, the HKMA's activities include supervision of AIs' internal AML/CFT policies, procedures and controls, conducting on-site examinations and off-site reviews, issuance of statutory and non-statutory guidance and training and maintaining regular supervisory contacts to ensure regulatory compliance.</p> <p>Relevant authorities (including the MA) review the AMLO and the AML Guideline maintain consistency with international AML/CFT standards and obligations, such as the FATF Recommendations and guidelines issued by the Basel Committee. The authorities have power under the AMLO to amend the AML Guideline published under this section and the AML Guideline was last updated in July 2012.</p>
<b>EC2</b>	<p>The supervisor determines that banks have adequate policies and processes that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, for criminal activities. This includes the prevention and detection of criminal activity, and reporting of such suspected activities to the appropriate authorities.</p>
<b>Description and findings re EC2</b>	<p>The HKMA tests whether the AIs have taken all reasonable measures to ensure that proper safeguards exist to mitigate the risks of money laundering / terrorist financing through on-site examinations and off-site reviews. In addition to the off-site review of policies and procedures, the examination team carries out its tests, inter alia, through selecting profiles and account statements of customers to ensure that risk rating, due diligence and monitoring has been carried out appropriately as well as checking completeness of certain databases and selecting transaction files.</p> <p>Responsibility for AML supervision rests with the Banking Supervision Department (BSD), shared between case teams and a specialist AML team (AML Team). In order to ensure that its supervision in this area is effective, the HKMA is significantly strengthening the resources dedicated to the specialist AML Team. The AML resources have been more than doubled over a three year period and, as a comparator, their numbers represent more than 10 percent of the BSD.</p> <p>In practice, AIs regarded as higher risk for money laundering activities are subject to more frequent, within a three to five year cycle, in-depth examinations by the AML Team. The AML/CFT risk of an AI is normally captured in the assessment of its reputational and legal risks in the context of an annual risk-based assessment which takes into account supervisory judgment over the inherent risks and adequacy of the relevant risk management systems, in addition to relevant wider factors such as the business and risk profile of the individual AI. As the HKMA adopts a risk-based approach to its supervision, while an AI assessed as normal risk may be subject to a specialist AML examination cycle in excess of three to five years, it may still be subject to a risk-based examination, containing some thematic or general AML examination more frequently.</p> <p>The types of examination undertaken by the specialist AML team are (i) Tier-2 AML examinations covering full scope review of AIs' AML/CFT controls; and (ii) Thematic AML examinations a series of which were conducted in 2012 on transaction monitoring and suspicious transaction reporting. In addition, a Tier-1 AML examination, conducted</p>

	<p>as part of a risk-based examination, involves less detailed review of AML controls than the Tier-2 examination and is conducted by the general onsite examination team.</p> <p>To supplement the thematic examinations on suspicious transaction monitoring, in March 2013, the BSD conducted an exercise to collect and analyze information on the effectiveness of suspicious transaction reporting and post reporting actions. In particular, AIs were requested to demonstrate how they had operationalized the specific requirements of the AML Guideline for suspicious transaction reporting and post reporting risk mitigation. (As noted above, although guidelines are not directly enforceable they are, as also noted under CP1, regarded as indicative of conformity or not with the underlying ordinance. Hence the HKMA refers to guidelines as imposing requirements and this assessment follows this practice. Please also refer to CP1). Recognizing that compliance can be challenging for AIs, the HKMA published a guidance paper on sound industry practices for transaction screening, transaction monitoring and suspicious transaction reporting in December 2013 and is planning further guidance to feedback to the industry best practices from the findings of the thematic review.</p> <p>The AML Team also monitors reporting levels and trends relating to suspicious transactions reports made to the Joint Financial Intelligence Unit (JFIU) and meets with the JFIU on an annual basis to discuss trends and issues of concerns. The HKMA indicated that there is, broadly, a good reporting culture in the banking sector and noted that reporting of suspicious transactions has doubled in volume following the coming into force of the AMLO and closer attention paid by the HKMA.</p> <p>Although in depth examinations are risk based, all banks will be subject to review of their internal AML/CFT policies, procedures and controls and most banks have been subject to an on-site assessment. Failure to adopt adequate practices by the bank would lead to remedial requirements by the HKMA in the context of its supervisory relationship and the case team would follow up actions required of the bank. In the event that more stringent enforcement practices were needed, the AMLO provides (sections 21 and 71) for public reprimand, order to take remedial actions and pecuniary penalties, or prosecution of contraventions of specified provisions. Although such measures have not yet been applied, the enforcement framework is being used to investigate, for the purpose of considering taking disciplinary actions or instigating prosecutions under the AMLO, where there are grounds to believe the AMLO has been breached.</p> <p>The HKMA has also held a sequence of seminars, in April 2013, for senior management (chief executives, heads of compliance and MLROs) to communicate messages on strengthening AML/CFT risk management and high ethical and professional standards. After the seminars the HKMA conducted a survey to assess action taken by the Boards in response to the seminars in relation to AML/CFT controls.</p> <p>The legislation sets out standards that AIs must meet and provides that AIs must take all reasonable measures (a) to ensure that proper safeguards exist to prevent a contravention of any requirement under the AMLO (CDD and record keeping) and (b) to mitigate money laundering and terrorist financing risks.</p>
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	<p>The AML Guideline, as noted in EC1, is a statutory guideline issued under the AMLO and sets out minimum standards on AML/CFT policies, procedures and controls (AML/CFT systems) that AIs should have in place to prevent and detect money laundering activities and to report suspected activities to relevant authorities. The Guideline also sets out how AIs may comply with the statutory requirement to report suspected criminal activities to the appropriate authority, i.e. the JFIU. The AMLO and AML Guideline seek to reflect the relevant FATF recommendations and the Basel Committee's Statement of Principles, including "know your customer."</p> <p>Additionally, and more broadly, the need for AIs to meet standards of conduct and sound and prudent business practices is reflected in the BO, including in the minimum authorization criteria under the BO Schedule 7. Further, the SPM underpins the importance of high ethical and professional standards and guarding against the risk of being used for criminal activities. In particular the modules relating to Corporate Governance (CG-1), Code of Conduct (CG-3) and Competence and Ethical Behavior (CG-6) establish expectations for the role of the board in establishing ethical standards, codes of conduct and as necessary investigating apparent instances of unethical behavior by employees.</p>
<b>EC3</b>	<p>In addition to reporting to the financial intelligence unit or other designated authorities, banks report to the banking supervisor suspicious activities and incidents of fraud when such activities/incidents are material to the safety, soundness or reputation of the bank.<sup>76</sup></p>
<b>Description and findings re EC3</b>	<p>Under the SPM module on code of conduct (CG-3) "AIs are expected to report matters which could give rise to fraud, deception, theft, forgery, corruption or other illegal activities to the HKMA and other relevant regulatory or law enforcement authorities." Further, under the AMLO AIs are required to report any suspicions of terrorist financing or sanction violations to the MA.</p> <p>It is the HKMA's experience that AIs report criminal activities to the JFIU or other relevant law enforcement agency (e.g., the Commercial Crime Bureau of the Hong Kong Police in the case of Fraud) for investigation and, as relevant, subsequent prosecution. Furthermore, the HKMA expects AIs to report to it cases of suspicious or fraudulent transactions when such activities or incidents are material to the AI and the HKMA's experience is again that AIs have generally met this expectation.</p> <p>The HKMA has recently (October 2013) established an information sharing protocol with the Hong Kong Police in which the Police will share, on a quarterly basis, information regarding serious money laundering prosecutions, which may be material to the safety, soundness or reputation of the bank though no such incidents have yet occurred. After assessment, the AIs concerned may be required to report to the HKMA details of the case and arrange internal audit to identify any control weaknesses and remediation actions needed. The HKMA will follow up or apply supervisory measures</p>

<sup>76</sup> Consistent with international standards, banks are to report suspicious activities involving cases of potential money laundering and the financing of terrorism to the relevant national centre, established either as an independent governmental authority or within an existing authority or authorities that serves as an FIU.

	<p>on proportionate approach.</p> <p>In case of any suspicion of terrorist financing or sanction violations, AIs usually first report the matter to their case officer before it is passed to the AML Team.</p>
<b>EC4</b>	<p>If the supervisor becomes aware of any additional suspicious transactions, it informs the financial intelligence unit and, if applicable, other designated authority of such transactions. In addition, the supervisor, directly or indirectly, shares information related to suspected or actual criminal activities with relevant authorities.</p>
<b>Description and findings re EC4</b>	<p>There is a legal obligation to inform the relevant criminal authorities of any property known or suspected to be the proceeds of (whether in whole or in part, directly or indirectly), or to have been used or to be used in connection with, an indictable offence where section 25A(1) of either Drug Trafficking (Recovery of Proceeds) Ordinance (DTROP) or Organized and Serious Crimes Ordinance (OSCO) applies. No disclosure by the MA of this nature can be treated as a breach of his official secrecy obligation (as provided by section 25A(3) of DTROP or OSCO) and gateways under the BO facilitate such exchanges.</p> <p>In general, when identifying suspicious transactions in the course of examination, the AML Team requires the AI to report the case to the police JFIU or the Independent Commission Against Corruption. However, where there are concerns that management is involved or is uncooperative, or where it is assessed that a report to JFIU may consolidate information or provide a better overall picture of the criminal activities, then the HKMA will itself undertake the reporting, in addition to any other supervisory action that is appropriate. Although relatively few in number, the HKMA has made a number of suspicious transaction reports to JFIU when the HKMA has been in possession of information that the HKMA may have received earlier than other parties (e.g., AIs) or that may not be available to the AIs.</p>
<b>EC5</b>	<p>The supervisor determines that banks establish CDD policies and processes that are well documented and communicated to all relevant staff. The supervisor also determines that such policies and processes are integrated into the bank's overall risk management and there are appropriate steps to identify, assess, monitor, manage and mitigate risks of money laundering and the financing of terrorism with respect to customers, countries and regions, as well as to products, services, transactions and delivery channels on an ongoing basis. The CDD management program, on a group-wide basis, has as its essential elements:</p> <ul style="list-style-type: none"> <li>(a) a customer acceptance policy that identifies business relationships that the bank will not accept based on identified risks;</li> <li>(b) a customer identification, verification and due diligence program on an ongoing basis; this encompasses verification of beneficial ownership, understanding the purpose and nature of the business relationship, and risk-based reviews to ensure that records are updated and relevant;</li> <li>(c) policies and processes to monitor and recognize unusual or potentially suspicious transactions;</li> <li>(d) enhanced due diligence on high-risk accounts (e.g., escalation to the bank's senior management level of decisions on entering into business relationships with these accounts or maintaining such relationships when an existing relationship becomes high-risk);</li> </ul>

	<p>(e) enhanced due diligence on politically exposed persons (including, among other things, escalation to the bank's senior management level of decisions on entering into business relationships with these persons); and</p> <p>(f) clear rules on what records must be kept on CDD and individual transactions and their retention period. There is a minimum five year retention period.</p>
<p><b>Description and findings re EC5</b></p>	<p>The AMLO and AML Guideline specify that an AI should:</p> <ul style="list-style-type: none"> <li>• take all reasonable measures to ensure that proper safeguards exist to mitigate the risks of money laundering / terrorist financing (ML/TF) (AMLO Schedule 2) and to ensure compliance with this requirement should implement appropriate internal AML/CFT systems (AML Guideline);</li> <li>• continuously review AML/CFT systems to ensure they remain up-to-date and be communicated to all staff (AML Guideline);</li> <li>• cover the following elements in the AI's policies and procedures in addition to basic customer due diligence standards: <ul style="list-style-type: none"> <li>○ a customer acceptance policy that requires the identification of customers that pose a higher risk of money laundering (and terrorist financing) and applying enhanced customer due diligence (EDD) on these customers (AMLO Schedule 2 and AML Guideline Chapters 3 and 4);</li> <li>○ a customer identification, verification and due diligence process which includes identifying and verifying the identity of the direct customer, identifying and taking reasonable measures to verify the beneficial owner; conducting on-going due diligence and scrutiny throughout the relationship; and undertaking regular reviews of the existing records of the customer to ensure that they remain up-to-date and relevant (AMLO Schedule 2 and AML Guideline Chapter 4);</li> <li>○ policies and processes to monitor and identify unusual or potentially suspicious transactions, particularly in respect of higher-risk accounts (AMLO Schedule 2 Sections 5 and 15, AML Guideline Chapters 5 and 7 and the guidance paper "Good practices on transaction monitoring" issued in July 2008); NB following the assessment, the HKMA issued an updated paper on sound industry practices for transaction screening, transaction monitoring and suspicious transaction reporting issued in December 2013)</li> <li>○ senior management approval for the establishment of higher risk relationships (including politically exposed persons (PEPs)) and continuing the relationship after an existing customer or a beneficial owner is identified as a PEP (AMLO Schedule 2 and AML Guideline Chapter 4);</li> <li>○ clear rules on record keeping and retention period. Customer identification information and all transaction records must be retained for at least 6 years (AMLO Schedule 2 and AML Guideline Chapter 8).</li> </ul> </li> </ul> <p>Moreover, locally incorporated AIs with overseas branches or subsidiary undertakings are expected to put in place a group AML/CFT policy to ensure that all branches and subsidiary undertakings that carry on the same business as an AI in a place outside HKSAR have procedures in place to comply with CDD and record-keeping requirements similar to those imposed under AMLO Schedule 2 Parts 2 and 3 to the extent permitted by the law of that place. The AI should communicate the group policy to its overseas branches and subsidiary undertakings (AMLO Schedule 2 Section 22</p>

	<p>and AML Guideline). In addition, when a branch or subsidiary undertaking is unable to comply with the requirements that are similar to those imposed under Schedule 2 Parts 2 and 3 because this is not permitted by local laws, the AI should inform the MA and take additional measures to effectively mitigate the ML/TF risks faced as a result of the inability to comply with the above requirements.</p> <p>In terms of practical determination, the specialist AML Team monitors AIs' compliance with the AMLO and the AML Guideline through on-site examinations and off-site reviews. In-depth Tier-2 reviews/examinations take place on-site and evaluate the full scope of the AI's AML/CFT systems, using the examination checklist (as with other risk areas, the term "checklist" is something of a misnomer. In practice the checklist should be interpreted as "methodology" that requires relevant expertise, use of judgment, and the ability to focus on issues that arise. It is not a "tick box" approach). The checklist covers the following specific sections: AML/CFT systems and the risk based approach; Business conducted outside HKSAR; CDD - the adequacy of, and compliance with an AI's AML/CFT policies, procedures and controls; Record Keeping; Correspondent Banking; Management Oversight (including the role of Compliance and Money Laundering Reporting Officer) and the role of internal audit and compliance in conducting reviews; Staff training; Transaction Monitoring; Wire Transfers; and also Tax Evasion.</p> <p>The checklist was updated and expanded in 2012 to take AMLO changes into account. Furthermore, in 2013, the checklist has been further updated to add a section on tax evasion and, taking into account experiences in the first 12 months under the AMLO regime, to better address "effectiveness" of controls.</p> <p>The examinations make an overall assessment on whether sound and effective ML/TF risk management systems have been put in place with relevance to the overall safety and soundness of the AI. In addition to the in-depth Tier-2 on-site examinations as mentioned above, the specialist AML Team also conducts thematic examinations on controls covering specific risk areas such as suspicious transaction reporting correspondent banking, trade finance and most recently private banking and tax evasion.</p> <p>In terms of assessing effectiveness of controls, following a review of the policies and procedures for compliance with the AMLO and AML Guidelines, sample testing and fieldwork is carried out to assess the effectiveness of application of these requirements in practice.</p> <p>In terms of verification of the overseas operations of AIs, the HKMA looks both at the AI's own group supervision and branch controls as well as conducting on-site examination of overseas branches.</p> <p>The HKMA organizes regular seminars for the banking sector to update the industry on the latest issues and developments in relation to AML/CFT.</p> <p>To support the implementation of AMLO, the provision of AML training to AIs' staff was significantly increased. Six workshops and seminars were held in 2012 for</p>
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	<p>approximately 1,600 bank staff covering all AIs in the jurisdiction. One of these, for MLROs, was conducted together with the JFIU, providing guidance on suspicious transaction reports and how AIs should manage the risks where suspicious transactions were noted. Further high level AML seminars were provided in April 2013 to update Heads of Compliance and Money Laundering Reporting Officers on the latest AML trends and developments in addition to reinforcing messages on the requirement for strong AML/CFT risk culture. At the request of the HKMA, the JFIU also participated in these seminars. Besides, two AML/CFT seminars with the theme of combating the laundering of proceeds of tax evasion were held in October 2013.</p> <p>The HKMA also issues circulars and guidance from time to time to assist AIs to meet their legal and regulatory obligations on AML/CFT. Previous examples include customer due diligence process for offshore companies, politically exposed persons (PEPs), and proof of address for personal customers. Some of this guidance is issued jointly with industry working groups. As noted in EC2, a guidance paper on best practices identified in recent thematic examinations on transaction screening, transaction monitoring and suspicious transaction reporting was published after the assessment in December 2013.</p> <p>With respect to supervisory determination of AIs' CDD practices, the HKMA indicated that while non-face-to-face account opening is permitted it is an area of close scrutiny and AIs are expected to undertake additional steps to verify the customer's identity (see Chapter 4, AML Guideline). Specifically in relation to private banking the AML Guideline states that AIs should not establish a private banking relationship without meeting the customer. In terms of corporate clients, the threshold for identifying beneficial ownership is 10 percent. While acknowledging challenges in some areas of verification (e.g., in relation to company registers in some jurisdictions, or verification of name, date of establishment and legal form with respect to trusts) the HKMA noted that verification of identity is an essential requirement. If a client is considered a high risk then the requirement under AMLO is that verification is also required down to 10 percent ownership, whereas in other non high-risk situations the verification requirement is 25 percent. Where these requirements cannot be met the customer should be rejected.</p> <p>CDD measures are based on a number of factors, not only geographic location. Under the AMLO, an AI must comply with special requirements when it knows that a customer or a beneficial owner of a customer is a politically exposed person (PEP), being an individual who is or has been entrusted with a prominent public function in a place outside the PRC. Where a person falls outside the definition of a PEP because his function is located inside the PRC (including HKSAR)(a "domestic PEP"), the AML Guideline provides that AIs should adopt a risk-based approach to determining whether to apply the special requirements under AMLO.</p>
<b>EC6</b>	<p>The supervisor determines that banks have in addition to normal due diligence, specific policies and processes regarding correspondent banking. Such policies and processes include:</p> <ul style="list-style-type: none"> <li>(a) gathering sufficient information about their respondent banks to understand fully the nature of their business and customer base, and how they are</li> </ul>

	<p>supervised; and</p> <p>(b) not establishing or continuing correspondent relationships with those that do not have adequate controls against criminal activities or that are not effectively supervised by the relevant authorities, or with those banks that are considered to be shell banks.</p>
<p><b>Description and findings re EC6</b></p>	<p>The fact that correspondent banking is regarded as a high-risk area from a money laundering / terrorist financing perspective is reflected in the AMLO which requires AIs to subject their correspondent banking relations to enhanced scrutiny. Senior management approval is required before the establishment of any new correspondent banking relationship (AMLO). AIs should have policies and procedures in place to gather and assess the following information (AMLO and AML Guideline, Chapter 11):</p> <ul style="list-style-type: none"> <li>• respondent bank’s ownership, management structures, major business activities and location;</li> <li>• its money laundering prevention efforts and adequacy of AML/CFT controls;</li> <li>• the system of bank regulation and supervision in the respondent bank’s country;</li> <li>• the reputation and history of the respondent bank; and</li> <li>• the purpose of the account.</li> </ul> <p>AIs must not establish or maintain a correspondent banking relationships with a bank outside HKSAR unless they are satisfied that the bank is effectively supervised by an appropriate authority that performs functions similar to those of the MA in that place. Further, AIs must not establish or maintain correspondent banking relationships with shell banks (AMLO). AIs should take appropriate measures to ensure that they do not enter into or continue a correspondent banking relationship with a bank which is known to permit its accounts to be used by a shell bank (AML Guideline Chapter 11).</p> <p>On and off-site practices as noted above (e.g., EC2) are used to obtain supervisory determination of correspondent banking polices and processes. The HKMA indicated that in-depth Tier 2 AML examinations always include a focus on the special due diligence requirements for correspondent banking relationships as prescribed in the AMLO. The onsite examination team will sample respondent bank profiles to ascertain whether the AI has complied with the requirements, including obtaining information required and senior management approval for the relationship. Questionnaires designed by the AI and completed by the respondent bank are also checked for detail and completeness.</p> <p>In reinforcing the requirements of the AMLO the HKMA held seminars for Heads of Compliance and Money Laundering Reporting Officers in April 2013 to set out the risks and supervisory expectations with regard to correspondent banking. Also, the AML Guideline provides more detail on expectations not only with relation to new but also pre-existing correspondent banking relationships.</p>
<p><b>EC7</b></p>	<p>The supervisor determines that banks have sufficient controls and systems to prevent, identify and report potential abuses of financial services, including money laundering and the financing of terrorism.</p>
<p><b>Description and</b></p>	<p>As required by the on-going authorization criteria under the BO Schedule 7, AIs must</p>

<b>findings re EC7</b>	<p>have in place adequate systems of control and carry on their business with integrity, prudence and the appropriate degree of professional competence. (Please see also CP 5.) This includes having an effective system to combat money laundering, terrorist financing and other fraudulent practices. In particular, as stated in the SPM module on General Risk Management Controls (IC-1), controls relating to the prevention of money laundering are among the core components of AIs' internal control systems.</p> <p>Under the AMLO Schedule 2, AIs must take all reasonable measures to mitigate money laundering and terrorist financing risks. To ensure compliance with this requirement, the AML Guideline specifies that AIs should implement appropriate internal AML/CFT systems. More specific guidance on the identification and reporting of potential abuses is provided in the AML Guideline Chapters 6 and 7.</p> <p>The HKMA determines that AIs have adequate systems and controls in place to combat money laundering, terrorist financing and fraudulent activities through:</p> <ul style="list-style-type: none"> <li>• conducting regular on-site examinations and off-site reviews;</li> <li>• requiring AIs to submit an external auditor's report on the relevant systems of control under BO section 59(2), if needed.</li> </ul> <p>As mentioned above, the HKMA conducts periodic on-site examinations to review the internal control systems of AIs. Findings are discussed with the AI's management and remedial measures required, which are followed up by the AI's case team. The assessors review of files noted evidence of monitoring and supervisory follow up by the HKMA though no instances necessitating legal sanction. The HKMA noted that a particular concern related to individuals being placed into AML roles without the relevant or sufficient skills and this was an area in which they had to act and the individuals had been removed from the AI following the concern raised by the HKMA. The formal use of powers was not necessary in order to achieve the required outcome.</p>
<b>EC8</b>	<p>The supervisor has adequate powers to take action against a bank that does not comply with its obligations related to relevant laws and regulations regarding criminal activities.</p>
<b>Description and findings re EC8</b>	<p>Any failure of an AI to comply with the AMLO will, in addition to the AMLO-related sanctions that may be imposed on the relevant persons within the AI, call into question whether the AI continues to satisfy the minimum authorization criteria under the BO Schedule 7 which are continuing in nature. Failure to meet these criteria constitutes a ground for revocation of its authorization under the BO.</p> <p>Moreover, should it appear warranted to conduct an independent investigation, under BO (section 117), the FS may, on the base of a report from the MA, if it appears to the MA that it is in the interests of depositors of an AI or a former AI, or in the public interest that an inquiry should be made into its affairs, business or property and the MA reports to the FS to that effect, the FS may appoint a competent person to report to him and to the MA on the results of his investigation.</p> <p>Relevant authorities are empowered under AMLO section 11 to initiate investigations if they have reasonable cause to believe that an offence under AMLO may have been committed or have reason to inquire whether an AI has contravened a specified provision. Investigators are empowered under AMLO to require the person under</p>

	<p>investigation or those believed to be in possession of relevant documents/information to produce documents and/or attend before the investigator to answer questions. Investigators can also obtain search warrants to enter premises and search for, seize and remove documents under the AMLO.</p> <p>AMLO section 21 empowers the relevant authorities to take disciplinary actions against the financial institution for breaches of specified provisions relating to the CDD and record-keeping requirements. Possible disciplinary actions include public reprimand, remedial actions and pecuniary penalties. In addition, there is power under the AMLO for the MA to prosecute contraventions of specified provisions. (See "Guideline on Exercising Power to Impose Pecuniary Penalty).</p> <p>The HKMA employs a structured framework to ensure the effective use of supervisory measures for anti-money laundering / counter-terrorist financing purposes. To facilitate the adoption of a proportionate approach for considering supervisory measures, the HKMA broadly categorizes available supervisory measures into 3 levels (I, II and III) that correspond to three increasing levels of seriousness of AML deficiencies revealed.</p> <p>Level I measures respond to deficiencies of "emerging" concern which, although not posing immediate risks to the AI, reveal unsatisfactory level of compliance. Level II measures are in response to deficiencies of "significant" concern, including relating to AML obligations for customer due diligence and record keeping. Level III measures are to address large-scale and persistent AML deficiencies of "severe" concern and which may have systemic implications. Generally, as indicated in a circular letter issued in 2006, the HKMA would seek to rely on its administrative and prudential measures to address deficiencies at levels I and II, while statutory powers, under the BO, would be used in respect of level III issues. In addition to these administrative and prudential measures, the HKMA also has a wide range of criminal and disciplinary sanctions under AMLO.</p> <p>Broadly speaking in practice, though, while level I and some level II situations have been dealt with through the use of administrative or prudential measures some level II situations have been addressed through the use of statutory powers. To date there has not been a level III situation.</p> <p>Moreover, the HKMA takes the AML assessment, particularly in the case of deficiencies, into its assessment of the AI's CAMEL ratings. The assessors noted that the findings and discussion in the CAMEL assessment were typically highly detailed and carried weight in the overall assessment of the AI.</p> <p>The supervisory measures which may be taken, and which have been taken, to address the categories noted above range from the use of various administrative or prudential measures (e.g., issuing a letter requiring the AI to remediate the deficiencies identified, commission audit reports for a comprehensive and in-depth review of the problems under BO section 59(2)) to the exercise of general statutory powers available to the MA under the BO, and/or taking disciplinary actions (e.g., publicly reprimand or imposing a pecuniary penalty) against the AI for non-compliance with the AMLO or</p>
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	<p>the AML Guideline. The HKMA has not yet had cause to use its statutory powers under the AMLO which has only been effective since April 2012 although a number of investigations have commenced.</p> <p>Separately, the case team, follows-up with AIs on the remediation of control deficiencies; in order to monitor subsequent compliance AIs are required to provide a formal response to the on-site examination findings and recommendations. Where necessary, the HKMA either requests the internal audit to validate the work done, or conducts this work through onsite examinations, or alternatively an external review will be commissioned as referred to above.</p>
<p><b>EC9</b></p>	<p>The supervisor determines that banks have:</p> <ul style="list-style-type: none"> <li>(a) requirements for internal audit and/or external experts<sup>77</sup> to independently evaluate the relevant risk management policies, processes and controls. The supervisor has access to their reports;</li> <li>(b) established policies and processes to designate compliance officers at the banks' management level, and appoint a relevant dedicated officer to whom potential abuses of the banks' financial services (including suspicious transactions) are reported;</li> <li>(c) adequate screening policies and processes to ensure high ethical and professional standards when hiring staff; or when entering into an agency or outsourcing relationship; and</li> <li>(d) ongoing training programs for their staff, including on CDD and methods to monitor and detect criminal and suspicious activities.</li> </ul>
<p><b>Description and findings re EC9</b></p>	<p>In terms of supervisory oversight and determination, and in addition to the on-site examinations and off-site review (see EC2 in particular) the HKMA may also perform the following measures:</p> <ul style="list-style-type: none"> <li>• obtain information from AIs for off-site reviews and meeting with senior management;</li> <li>• meetings with internal and/or external auditors of AIs; and</li> <li>• request AIs to submit a report prepared by an auditor under BO section 59(2) on adequacy of controls for specific areas.</li> </ul> <p>In the process of stepping up AML/CFT supervision, the HKMA has increasingly required AIs' internal and external auditors to conduct specific reviews of their AML/CFT systems regarding weaknesses &amp; surrounding money laundering cases / suspicious activities and remediation of control deficiencies.</p> <p>Underpinning the supervisory activity are the requirements set out in AMLO, BO and the guidance set out in the various guidelines issued by the HKMA:</p> <ul style="list-style-type: none"> <li>• AIs' compliance and audit functions should regularly and independently</li> </ul>

<sup>77</sup> These could be external auditors or other qualified parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions.

	<p>evaluate on a periodic basis the adequacy of and compliance with the AIs' own policies, procedures and controls to prevent money laundering activities (AML Guideline). AMLO section 9 and BO sections 55 and 56 empower the MA to examine any record or document relating to AIs, including reports prepared by AIs' internal auditors and external experts.</p> <ul style="list-style-type: none"> <li>• AIs should appoint a director or senior manager as a compliance officer who has overall responsibility for the establishment and maintenance of the AIs' AML/CFT systems (AML Guideline).</li> <li>• AIs are required to appoint a senior member of the AI's staff as the money laundering reporting officer (MLRO) as the central reference point for reporting suspicious transactions (AML Guideline). The compliance officer and MLRO should be of sufficient seniority and authority, and have sufficient resources, including staff, to enable them to perform their functions and to discharge their responsibilities effectively (AML Guideline).</li> <li>• The Board and senior management of an AI should communicate a culture emphasizing high standards of ethical behavior at all levels of the AI. In addition, Boards should establish policies and procedures to ensure compliance with ethical values (SPM modules on Operational Risk, Reputational Risk Management, Corporate Governance and Competence and Ethical Behavior).</li> <li>• The SPM module on reputational risk highlights the importance of having an adequate human resources policy to recruit, develop and retain high quality staff and points out that deficiencies in employment and staff management practices could lead to problems including staff incompetence / misconduct.</li> <li>• AIs are required to implement a clear and well articulated policy for ensuring that all staff receive adequate AML/CFT training, ensuring they are aware of their legal obligations, internal policies and procedures, techniques for detecting suspicious transactions or unusual activities and customer identification requirements, etc. This includes the requirement for regular refresher training (AML Guideline).</li> </ul> <p>Further, the AMLO requires AIs to take all reasonable measures to: (a) ensure that proper safeguards exist to prevent a contravention of the AMLO (CDD and record keeping) and (b) mitigate money laundering and terrorist financing risks.</p> <p>The practices for supervisory determination are as set out under EC5 above. The MA requires the compliance and audit function to regularly review the AI's AML/CFT systems and draws attention to areas of focus, such as adequacy of suspicious transaction reporting or AML/CFT awareness. Access to such reports by the MA is provided under both the BO and the AMLO.</p> <p>The MA has, in the AML Guideline, issued detailed guidance on the role and resources afforded to Compliance Officers and MLROs. AIs must establish and maintain appropriate staff screening policies and processes and provide adequate and appropriate staff training.</p>
<b>EC10</b>	<p>The supervisor determines that banks have and follow clear policies and processes for staff to report any problems related to the abuse of the banks' financial services to either local management or the relevant dedicated officer or to both. The supervisor also determines that banks have and utilize adequate management information</p>

	systems to provide the banks' Boards, management and the dedicated officers with timely and appropriate information on such activities.
<b>Description and findings re EC10</b>	<p>In terms of the regulatory framework surrounding reporting of abuse of financial services, the AML Guideline specifies that AIs should establish procedures for reporting suspicious transactions and ensure that their staff are made aware of their own personal legal obligations under DTROP, OSCO and United Nations (Anti-Terrorism Measures) Ordinance (UNATMO) (to report suspicious transactions to their institution's MLRO and that they can be held personally liable for failure to report information to the authorities).</p> <p>The reporting requirement is mandatory. Section 25 A of the DTROP imposes a statutory duty on a person, who knows or suspects that any property in whole or in part directly or indirectly represents the proceeds of drug trafficking, or was used or is intended to be used in that connection, to make as soon as it is reasonable for him to do so a disclosure of that knowledge or suspicion to an authorized officer. Section 25A of the OSCO imposes the same requirement in respect of an indictable offence. Both DTROP and OSCO further makes it an offence for a person to fail to make such disclosure, which is punishable by fine and imprisonment. Likewise, UNATMO creates the reporting requirement for knowledge or suspicion of terrorist property and the offence of failure to disclose.</p> <p>The AML Guideline also specifies that each AI should appoint a designated officer as a MLRO to whom all suspicious cases should be reported directly by staff. The MLRO should have means of reporting and liaising efficiently with the JFIU operated by the Police and the Customs and Excise Department. The role and responsibility of the MLRO should be clearly defined in AIs' reporting procedures.</p> <p>In accordance with the SPM module Corporate Governance of Locally Incorporated Authorized Institutions (CG-1), the board and senior management of an AI should approve key risk management policies (which should include the prevention of money laundering) and oversee management in developing policies and practices to manage risk. SPM module on General Risk Management Controls (IC-1) also specifies that controls relating to the prevention of money laundering should be part of an AI's internal control system. The high level controls should cover an effective channel of communication whereby relevant cases can be brought up to the management's attention. The requirements for senior management oversight in relation to AML/CFT controls also exist in the AML Guideline.</p> <p>To determine that AIs' reporting procedures are appropriate and effective, the HKMA uses the on-site examinations by the specialist AML team. The team will:</p> <ul style="list-style-type: none"> <li>• review procedures for making an internal disclosure report; and the requirement that all disclosures reports must reach the MLRO (or designated function) without undue delay;</li> <li>• ascertain whether the relevant staff have sufficient awareness and understanding of the reporting procedures by seeking documentary evidence that the procedures have been distributed and read by all relevant staff and, by interviewing staff, etc.;</li> </ul>

	<ul style="list-style-type: none"> <li>• examine the register for recording all internal disclosure reports made by the staff to the MLRO and the register of all disclosures made to the JFIU to ensure that the written reporting procedures are being followed in practice.</li> </ul> <p>In addition, the specialist AML Team performs testing of transactions to identify whether suspicious transactions have been duly identified and reported by staff. In particular, the specialist AML Team:</p> <ul style="list-style-type: none"> <li>• reviews the MLRO's justification for not reporting any internal disclosure reports;</li> <li>• reviews the quality of the reports made to the JFIU to check if they contain necessary details to meet the legal requirement with any matter on which the suspicion is based (including the full details of the customer) to facilitate investigation to be made by the JFIU;</li> <li>• checks that the AI conducts an appropriate review of a business relationship upon the filing of a report to the JFIU and takes appropriate action to mitigate the risks;</li> <li>• reviews documents (e.g., minutes of senior management meeting) to ensure that, the highest risk relationships were escalated to the AI's senior management to determine how to handle the relationship to mitigate any potential legal or reputational risks posed by the relationship.</li> </ul> <p>Overall, the specialist AML Team reviews the reporting lines within the organization as well as the timeframe and quality of reports during on-site examinations.</p>
<b>EC11</b>	<p>Laws provide that a member of a bank's staff who reports suspicious activity in good faith either internally or directly to the relevant authority cannot be held liable.</p>
<b>Description and findings re EC11</b>	<p>Under both DTROP and OSCO, a person commits an offence if he deals with any property, knowing or having reasonable grounds to believe that such property, in whole or in part, directly or indirectly represents any person's proceeds of drug trafficking or of an indictable offence. Section 25A(3) of both DTROP and OSCO provide that disclosure made under section 25A(1) of the respective Ordinances shall not be treated as a breach of any restriction upon the disclosure of information imposed by contract or by any enactment rule of conduct or other provision restricting disclosure of information and shall not render the person making the disclosure liable in damages for any loss arising out of such disclosure or of any act done or omitted to be done to the property concerned as a result of the disclosure.</p> <p>Section 25A(4) of both DTROP and OSCO extend the effect of section 25A in each of the respective Ordinances to disclosures made by an employee to an appropriate person in accordance with the procedures established by his employer for the making of such disclosure as it has effect in relation to disclosures to an authorized officer.</p> <p>Further, the AML Guideline provides that records must be maintained that would demonstrate staff have acted in a reasonable manner. The same guidance specifically provides that providing the staff act in good faith in deciding not to file a suspicious transaction report, it is unlikely there would be any criminal liability.</p> <p>During on-site examinations, the specialist AML Team reviews whether AIs provide clear guidance to their staff on circumstances that constitute a suspicious transaction. The team also assesses whether AIs make staff aware of their personal liability and</p>

	available defense under the DTROP and OSCO and encourage them to report suspicious transactions to their MLRO based on the established internal policies and procedures on a timely basis.
<b>EC12</b>	The supervisor, directly or indirectly, cooperates with the relevant domestic and foreign financial sector supervisory authorities or shares with them information related to suspected or actual criminal activities where this information is for supervisory purposes.
<b>Description and findings re EC12</b>	<p>The MA may disclose information under the BO section 120 (5)(f) to the other financial sector regulators in HKSAR, including the SFC, IA, and MPFA. The disclosure may be made, where the MA is of the opinion that it is desirable or expedient that information should be disclosed in the interests of depositors or potential depositors or the public interest or where disclosure will enable or assist the recipient to exercise his functions and it is not contrary to the interests of depositors, potential depositors or the public interest. The AMLO also contains gateways for disclosure to domestic authorities including the SFC and the IA and overseas regulatory organizations in the circumstances specified there.</p> <p>A MOU between the four relevant domestic authorities under AMLO was being finalized at the time of the assessment.</p> <p>The BO allows the MA to disclose information (subject to the attachment of conditions for disclosure of customer information of AIs) to non domestic supervisory authorities that exercise functions corresponding to those of the MA. This disclosure is subject to the MA being of the opinion that the relevant authority has adequate secrecy provisions and that the disclosure is in the interest of existing or potential depositors or the public interest. Normally, a condition will be attached to the disclosure requiring the relevant authority to keep the information confidential and not to disclose such information to third parties without the MA's prior approval. The HKMA indicated that they have received and been able to respond to queries from other supervisory authorities and AML issues are now a standard feature of supervisory colleges and the AML team has participated in these discussions.</p> <p>Following the enactment of AMLO, two working groups have been established to facilitate cooperation and exchange of information.</p>
<b>EC13</b>	Unless done by another authority, the supervisor has in-house resources with specialist expertise for addressing criminal activities. In this case, the supervisor regularly provides information on risks of money laundering and the financing of terrorism to the banks.
<b>Description and findings re EC13</b>	The relevant authority in HKSAR for addressing criminal activities rests with law enforcement agencies. Under the Hong Kong model, the actual investigation of criminal activities and the prosecution of criminal parties rest with the Police (e.g., the Commercial Crime Bureau and Narcotics Bureau) and the Department of Justice. The HKMA, however, has powers under the AMLO to initiate investigations and take criminal prosecution action, where appropriate, in respect of AIs' contravention of AMLO. The enforcement department of the HKMA is responsible for conducting investigation on the AML-related control failure of AIs. In view of such powers, the HKMA has in-house resources with specialist expertise including for Police liaison.

	<p>In terms of access to specialist skills and maintenance of such skills, the HKMA has taken a number of initiatives, including:</p> <ul style="list-style-type: none"> <li>• staffing policy - some former law enforcement officers from the Police and the ICAC, with relevant training and experience in financial intelligence analysis, financial and commercial crime investigation;</li> <li>• training policy - ensuring all staff attend internal and external training, including attendance on the Financial Investigation Course conducted by the Hong Kong Police and some overseas regulator training;</li> <li>• peer group exposure and involvement including <ul style="list-style-type: none"> <li>○ participation in international money laundering forums such as the FATF and Asia Pacific Group on Money Laundering, attend money laundering typology workshops specific to the banking sector; and</li> <li>○ participation by the AML team in local AML forums (as members and as speakers) such as the Hong Kong Chapter of the Association of Certified Anti-Money Laundering Specialists.</li> </ul> </li> </ul> <p>In terms of regular provision of information and training, the HKMA regularly issues circular letters to AIs to highlight Quarterly Crime Alerts issued by the Commercial Crime Bureau of the Police. The alert messages share with the banking industry information on recent trends and cases on commercial crimes that have implications for the banking sector, including modus operandi. The JFIU also publishes a quarterly report (referred to in the AML Guideline) which includes matters of interest and feedback to the financial sectors.</p> <p>In discussion with firms, the assessors confirmed that the HKMA places a high priority on AML awareness and training. All firms with whom the assessors spoke were aware of the seminar held by the MA addressed to all chief executives of AIs in HKSAR and that its message was that vigilance towards AML/CFT issues must be cultural and not a matter of administrative compliance.</p>
<b>Assessment of Principle 29</b>	Compliant
<b>Comments</b>	<p>The HKMA has demonstrated a high degree of commitment to enhanced regulatory and supervisory practice in relation to AML/CFT. In addition to legislative revision and issuance of guidelines, the HKMA has strongly promoted awareness of AML/CFT concerns and strengthened its specialist supervisory resources. The 2013 seminar addressed to the chief executives of AIs operating in HKSAR by the MA was a significant illustration of the HKMA's intent that AIs must embed AML/CFT practices into the corporate culture and not approach money laundering/terrorist financing risks as a compliance exercise.</p> <p>HKSAR has been an independent member of the Financial Action Task Force (FATF) since 1991, and of the Asia/Pacific Group (APG) on Money Laundering since 1997. The AML/CFT framework was last assessed by the FATF and the APG in 2008. The assessment report identified some deficiencies and since then the authorities have taken a number of steps to address the shortcomings identified. In a 2012 follow-up report the FATF considered that sufficient progress had been made to reach a level of compliance equivalent to largely compliant or compliant for all core and key recommendations and that in relation to the banking sector the current AML/CFT legal</p>

	<p>and regulatory framework for banking supervision is, from a technical compliance perspective, sound. HKSAR is scheduled to undergo its next AML/CFT assessment in 2017.</p> <p>It is important that the HKMA maintain its momentum in developing its AML/CFT supervisory approaches and delivers a strong track record of effective implementation. At the time of the BCP assessment, the new regulatory regime was only relatively recently in place.</p>
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## SUMMARY COMPLIANCE WITH THE BASEL CORE PRINCIPLES

	Grade	Comments
1. Responsibilities, objectives and powers	C	<p>The responsibilities and objectives of the HKMA related to banking supervision are both clear and comprehensive, supported by an underlying statutory framework. In using the Exchange Fund, the HKMA may have a view to maintaining Hong Kong's status as an international financial centre, but the Exchange Fund may only be used to support development if this will maintain the stability and the integrity of the monetary and financial systems of Hong Kong.</p> <p>It is clear from discussions with the authorities, supported by the exchange of letters between the MA and FS in 2003, that the HKMA mandate is interpreted in terms of promoting financial stability and ensuring a high quality of regulatory and supervisory standards, as well as robust, up to date financial market infrastructure. It is also clear that despite references to a regard for the status of Hong Kong as an international financial center this concept is subsidiary to the mandate for financial stability. In other words, the authorities are strongly committed and required to deliver the highest regulatory and prudential standards.</p> <p>However, the authorities should be mindful of the need to avoid any "objectives creep" such that competitive considerations in promoting Hong Kong as an international financial centre risk being viewed as an objective in their own right, decoupled from the financial stability objective. As demonstrated and experienced in other financial centers, the potential exists for a conflict between objectives focused on dimensions of both stability and the status of a financial centre and 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 in order to maintain Hong Kong's status as a vibrant open market.</p>
2. Independence, accountability, resourcing and legal protection for supervisors	LC	<p>The HKMA enjoys clear de facto but not de jure operational independence. While the HKMA has autonomy over its day-to-day operations and in the methods it uses to pursue its public policy objectives this is not underpinned by the law. There is a power in the BO (section 10) for the Chief Executive of the HKSAR Government to give directions to the MA with respect to the exercise of the MA's functions under the BO. Whilst no instance of the use of the power could be cited, the possibility of future use cannot be completely ruled out. In addition, there is no statutory provision that specifies the circumstances under which the MA can be removed from office, or that requires the public disclosure of the reasons for the dismissal of the MA. Overall, there is much evidence of good practice, and</p>



		important safeguards are in place, such as the potential for judicial review of decisions taken by government authorities, which mitigates the risk of any abuse of power. Nonetheless, the independence of the HKMA could be more fully protected.
3. Cooperation and collaboration	C	The HKMA has strong working relationships with other domestic financial sector supervisory authorities, with an ongoing exchange of information and discussions regarding issues of mutual interest and concern. The HKMA also demonstrated that they have good working relationships with other relevant foreign supervisory authorities, both those with which they have a formal MoU and those with which they continue to deal on a more informal basis. The HKMA also participates in supervisory colleges for foreign AIs that have a significant presence in Hong Kong.
4. Permissible activities	C	<p>The BO clearly defines the term bank and prohibits the use of the term and any derivations for institutions that are not licensed and supervised as banks (with some exemptions being permitted at the discretion of the MA). The taking of deposits from the public is clearly reserved for licensed AIs that are subject to ongoing supervision by the HKMA.</p> <p>The permissible activities of banks are defined quite broadly; however, the MA has the clear authority to judge the prudence and legality of the activities conducted by individual institutions.</p>
5. Licensing criteria	C	The HKMA has established a framework of rigorous policies and procedures to carefully review applications for entry into the domestic banking system, whether by a domestic or foreign entity. The HKMA has recently instituted the commendable initiative to meet key individuals as part of the licensing process. This will help to ensure that proposed candidates for Board or senior management positions are fit and proper for their respective positions.
6. Transfer of significant ownership	C	The BO clearly defines “significant ownership” and “controlling interest” and there are clear requirements for supervisory approval and notification in the case of any changes to the ownership structure. The HKMA expects locally incorporated AIs to consult with them regarding proposed changes in controllers in advance so that any prudential concerns can be addressed at an early stage.
7. Major acquisitions	C	The HKMA has broad supervisory powers under the BO to review and approve or deny acquisitions or investments by AIs. In conducting its review of proposals submitted by AIs, the HKMA analyzes various criteria to ensure that the AI will not be exposed to undue risks. It also determines that the acquisition or investment will not negatively impact the HKMA’s ability to conduct effective consolidated supervision.
8. Supervisory approach	C	The HKMA executes an excellent supervisory approach which combines sound risk analytical techniques and a broad range of

		inputs. The use of thematic exams and the integration between the SRP and CAMEL methodology provides a clear and forward looking basis for a holistic risk assessment process. The HKMA has created a disciplined and responsive approach on the “continuous” risk based principle and intervenes quickly with institutions when issues start to emerge. The supervisory process is informed by active consideration of the wider macro context and tools and techniques to enhance this approach continue to be developed, which is important as this is a general area for development within the supervisory community.
9. Supervisory techniques and tools	C	The HKMA conduct a well balanced supervisory approach, with an emphasis on preventative approaches, carefully integrating on and off-site surveillance techniques. Supervisory teams and specialists demonstrate a close knowledge of and insight into individual AIs and of the system wide dimensions. The annual risk assessment process enables the HKMA to adjust its supervisory priorities and as necessary its resources. The HKMA sets and communicates clear expectations to the industry and balances a readiness to challenge AIs’ practices with an openness to and understanding of AIs’ legitimate business concerns.
10. Supervisory reporting	C	The HKMA has wide powers of information gathering which it uses effectively. The authority receives standard prudential data from firms as well as much management information and supplementary data from surveys and ad hoc data as necessary. The HKMA is alert to the potential of seeking redundant information and reviews the necessity of its information requests periodically. Equally, when new returns are required (such as the new return with respect to exposures to mainland China) considerable care is taken in identifying comprehensive and granular data points to be reported in order to facilitate thorough analysis. The annual discipline of commissioning reports into the accuracy of returns and the potential to commission reports when needed from the external auditor on the underlying control systems for the preparation of information that is submitted to the HKMA provides a further level of control.
11. Corrective and sanctioning powers of supervisors	C	The HKMA has a strong set of powers under the BO and the HKMA has developed a firm reputation of being a reasonable but assertive authority which does not hesitate to act or to escalate its actions if necessary. In practice, the HKMA prefers preventative measures to remedial measures whenever possible, a stance that was confirmed by the assessors in dialogue with the industry. There is, however, no evidence of supervisory forbearance and the assessors’ review of extensive material provided by the HKMA, in addition to industry dialogue, indicated that the HKMA can and does use its range of powers in a timely manner.
12. Consolidated supervision	C	The HKMA has a strong legal and regulatory framework for consolidated supervision that it applies in practice. The HKMA carefully monitors actual and potential risks across the entire group

		structure, placing emphasis on corporate governance and robust risk management policies and procedures. The HKMA analyzes AIs on both a solo and consolidated basis.
13. Home-host relationships	C	Hong Kong is a major international financial center and the HKMA is a significant host jurisdiction, which puts a premium on the quality of home-host supervisory relationships. The HKMA participates in supervisory colleges and seeks to foster close bilateral relationships with key home state supervisors. Importantly, the HKMA is conscious of the need to continue developing relationships and evolving modes of communication and shared analysis for cross border groups.
14. Corporate governance	C	The HKMA places a great deal of emphasis on the importance of sound and effective corporate governance at AIs, irrespective of whether they are a local institution or the branch or subsidiary of a foreign bank. Their oversight of the quality of corporate governance serves as the basis for their on- and off-site work and they endeavor to develop a sound understanding of the effectiveness of Boards, Board Committees and senior management. This process includes periodic meetings with Board members, especially those who are independent directors and an interview process on a selective basis for candidates for Board positions.
15. Risk management	C	The HKMA has developed a supervisory process that focuses intensely on the risk management standards, policies and procedures at individual AIs. The emphasis on the quality and thoroughness of risk management is reflected in the SPM and guidance notes, the on- and off-site supervisory work, as well as the CAMEL rating process and Supervisory Review Process. The HKMA has been developing specialist teams to ensure that they can adequately assess the risks incurred by AIs and act as needed.
16. Capital adequacy	C	The HKMA has adopted the various components of Basel 2, 2.5, and 3 on or ahead of schedule. It has taken a more conservative approach for certain items recognized as regulatory capital than is required by the Basel standards. The HKMA applies both the three Basel ratios (common equity tier 1, tier 1 and total capital) as well as a trigger for each of these ratios on an individual AI basis, taking into consideration the unique characteristics of each institution. Supervisory staff regularly assesses AIs' capital management and planning and uses stress testing to assess the adequacy of capital.
17. Credit risk	C	The HKMA pays close attention to the credit risk policies and exposures of AIs and initiates discussions with management whenever issues arise. Supervisors conduct regular detailed on-site review of AIs' credit portfolios and require corrective actions on a timely basis if problems are detected. Market and macroeconomic conditions are taken into account when analyzing the credit risk within the banking system. Due to the size of Hong Kong AIs' exposure to residential mortgages and non-bank Mainland China, the HKMA has a system in place to carefully monitor these activities. The HKMA recently revised

		its reporting requirements for exposures to Mainland China to obtain much more granular information to support in-depth analysis on system-wide and individual AI bases.
18. Problem assets, provisions, and reserves	C	Through the use of reports submitted on a regular basis, the review of external auditor reports and on-site examinations, the HKMA closely monitors problem assets at individual AIs. Supervisory staff evaluates the adequacy of AIs' classification and provisioning policies for both on- and off-balance sheet exposures. Very importantly, the HKMA has addressed the conceptual difference between the accounting (incurred loss) and supervisory approaches to provisioning by requiring Hong Kong AIs to maintain a "regulatory reserve" to help neutralize the effect of accounting changes implemented in 2005. This has helped to ensure that AIs maintain adequate loan loss provisions.
19. Concentration risk and large exposure	C	The HKMA utilizes reports received from AIs on a quarterly basis to monitor large exposures (defined as equal to or exceeding 10 percent of the AI's capital base) and risk concentrations. Through on-site examinations, supervisory staff determines that AIs' management information systems identify and aggregate on a timely basis risk concentrations and that senior management and Boards of AIs utilize this information to actively oversee risk concentrations. In addition, AIs are required to include significant risk concentrations in their stress testing programs for risk management purposes.
20. Transactions with related parties	LC	The HKMA reviews the policies of AIs related to connected lending and reviews the credit files of connected exposures to ensure that facilities granted to connected parties are extended on an arm's length and prudent basis. The BO places restrictions on the amount of unsecured exposures, including loans that an AI may have with a related party; however, the current legal definition of "connected party" (or the equivalent term under the BO) does not explicitly cover an AI's senior management or the senior management of affiliates. In addition, boards of AIs are currently not required to provide prior approval to the write-off of exposures to related parties exceeding specified amounts or otherwise posing special risks to the AI.
21. Country and transfer risks	C	The HKMA requires AIs to actively manage country and transfer risks and it receives information on a quarterly basis in order to monitor the exposure of AIs to such risks. It has recently been giving heightened attention to the risk involved in AIs' exposure to certain European countries that have been experiencing difficulties, as well as to Mainland China. In addition, the Banking Supervisory Department makes use of the work being done by the HKMA's Financial Stability Surveillance Division and Macro Surveillance Committee, which are responsible for monitoring emerging macro-prudential risks facing the Hong Kong banking sector.
22. Market risk	C	The HKMA has implemented a comprehensive approach to the supervision of market risk, including the introduction of the most recent Basel amendments (Basel 2.5). While overall levels of market

		risk are modest for the international financial center, at less than 5 percent of risk weighted assets, the HKMA has ensured that all AIs with internal models approvals have been subject to reassessment to ensure they continue to meet standards for approval. The HKMA is particularly mindful of the need to tailor models to local market environment and puts a premium on new product processes and internal controls.
23. Interest rate risk in the banking book	C	Interest rate risk is, currently, a low impact risk for the banking sector in HKSAR but the HKMA demonstrates a cautious approach to ensuring that standards of risk management are maintained.
24. Liquidity risk	C	The HKMA has adopted a vigorous approach to liquidity risk supervision. Preparations are well underway for the timely introduction of the Basel liquidity framework and the intensity of on-site examinations and thematic reviews is increasing. The HKMA has a track record of challenging the liquidity assumptions and liquidity risk management behavior of the banking sector and encouraging and enforcing greater conservatism as necessary.
25. Operational risk	C	The HKMA has developed a balanced program for assessing ORM, utilizing on and off-site techniques and applying a risk based approach. Specialist teams for operational risk and technology risk have been created and there is a strong focus on raising awareness and encouraging industry wide good practice, such as through the issuance of circulars.
26. Internal control and audit	C	The HKMA's supervisory practices pay close attention to the adequacy of internal risk control and compliance functions within firms. Off-site techniques complement regular direct contact with Audit Committees and other control functions.
27. Financial reporting and external audit	LC	The HKMA devotes effort to ensuring effective communication channels with the external auditors. Furthermore, the HKMA's use of its powers to commission reports on AIs to be carried out by the external auditors for supervisory purposes further supports the nature of the relationship and the understanding of the HKMA's supervisory concerns. However, there are two areas in which the HKMA lacks powers and where the legislative framework could therefore be enhanced, in relation to powers to reject the appointment of an external auditor, when there are concerns over competence or independence, and direct power to access to the working papers of the external auditor even though the HKMA has, to date, been able to address issues that have arisen by indirect means.
28. Disclosure and transparency	C	The HKMA has implemented all Pillar 3 requirements in a timely manner through the Banking (Disclosure) Rules and has promoted the recommendations of the FSB's Enhanced Disclosure Task Force to the local market. The HKMA is also monitoring actual practice and is sensitive to the possible need to provide additional guidance to the AIs to ensure effective disclosure.

29. Abuse of financial services	C	The HKMA has demonstrated a high degree of commitment to enhanced regulatory and supervisory practice in relation to AML/CFT. In addition to legislative revision and issuance of guidelines, the HKMA has strongly promoted awareness of AML/CFT concerns.
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## RECOMMENDED ACTIONS AND AUTHORITIES

### COMMENTS

#### A. Recommended Actions

<b>Recommended Actions to Improve Compliance with the Basel Core Principles and the effectiveness of regulatory and supervisory frameworks</b>	
<b>Reference Principle</b>	<b>Recommended Action</b>
1. Responsibilities, objectives and powers	As demonstrated and experienced in other financial centers, the potential exists for a conflict between objectives focused on dimensions of both stability and the status of a financial centre and 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 in order to maintain Hong Kong's status as a vibrant open market.
2. Independence, accountability, resourcing and legal protection for supervisors	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 HKSAR to give directions to the MA may be exercised. It is also 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. In the interim, an exchange of letters between the authorities would address both the use of section 10 powers under the BO and the appointment/dismissal of the MA.
7. Major acquisitions	It is recommended, as the HKMA has noted, 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.
8. Supervisory approach	It is recommended that, in keeping with its existing plans, the HKMA continue to intensify its focus on business models and strategy and providing greater consideration to cross-sectoral issues. Please see also the recommendation for CP13.
9. Supervisory techniques and tools	It is recommended that the HKMA pay close attention to the frequency of on-site review of the AIs which are incorporated overseas, i.e., the foreign branches in HKSAR. Similarly, the HKMA should consider a review and as necessary a revision of internal guidance relating to foreign branches.

12. Consolidated supervision	It is recommended that the HKMA consider formalizing its process for analyzing non-financial activities of UHCs.
13. Home-host relationships	It is recommended that the HKMA maintain 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. This recommendation is part of a wider initiative that also concerns CP8.
20. Related parties	It is recommended that the HKMA execute 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. In addition, 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.
27. 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. Second, it is recommended that a supervisor be granted the direct power to access external auditors' working papers, where necessary.
28. Disclosure and transparency	It is recommended that the HKMA review best practices in other countries and consider publication of time series data sourced from its regulatory returns, disclosed on an individual institution bases, that would enhance the public and financial community's understanding of AIs' operations and risk profile.

## B. Authorities' Response to the Assessment

**68. The Hong Kong authorities appreciate the comprehensive and positive assessment of Hong Kong's banking sector and welcome the IMF's view that Hong Kong, as a major international financial center, maintains a very high level of compliance with the BCPs for Effective Banking Supervision.** The assessment contains some observations and recommendations (for example those in relation to banks' external auditors and connected parties) which could help further enhance banking supervision in HKSAR. The authorities will review these recommendations and give due consideration to their adoption, as HKSAR remains committed to the highest standards of banking regulation and supervision.

**69. In relation to BCP 2, the authorities concur with the IMF that the MA enjoys clear de facto operational independence in the performance of his functions.** In respect of the question of de jure independence, however, the authorities would like to reiterate (as on the occasion of the 2003 FSAP assessment of HKSAR) that the reserve power vested in the Chief Executive of HKSAR to give directions to the banking regulator reflects the government's ultimate responsibility to formulate monetary and financial policies and regulate and supervise financial markets as enshrined in the Basic Law. The power, which appears in section 10 of the BO, has never been used and would

only be used as a tool of last resort to implement specific remedial measures in the most critical and extreme circumstances. In order to exercise the reserve power, the Chief Executive of HKSAR would have to be satisfied that any direction given is in the public interest and consistent with the objectives of the BO and with the Basic Law, and the Chief Executive of HKSAR's decision to issue a direction may be subject to judicial review. Hence there are safeguards against arbitrary use of the reserve power and, given these qualifications, the authorities consider that the power does not in fact substantively compromise the operational independence of the MA as banking supervisor.

**70. Also in connection with BCP2, the authorities consider that the existing arrangements for the removal of the MA as (the head of) the banking supervisor are in practice adequate to preserve his independence.** The FS is empowered to revoke the appointment of the MA and, should he consider doing so, he will be required under the common law to act reasonably and take all relevant factors into consideration. The FS's decision may be subject to judicial review. The letter of appointment between the FS and the MA makes it clear that it is not the intention to terminate the MA's employment except for cause, such as his inability to discharge, or adequately carry out, his functions or duties; serious misconduct; conviction of a criminal offence punishable by imprisonment; or bankruptcy. In the interests of transparency, the HKMA makes public announcements of all of its staff changes at the level of Executive Director or above; including the reasons for such staff changes.

**71. Encouraged by the IMF's overall assessment of banking supervision in HKSAR, the Hong Kong authorities will continue to refine and strengthen the local regulatory and supervisory framework in line with international best practice to promote the stability and effective working of the banking system in HKSAR.**