

For information

Legislative Council Panel on Financial Affairs

Regulatory and Oversight Framework on Octopus Card and EPS

Purpose

This paper sets out the framework for regulatory oversight by the Hong Kong Monetary Authority (HKMA) on the Octopus Card and EPS.

Regulatory framework for Octopus

2. When the regulatory approach for multi-purpose stored value cards (MPC) was formulated in mid-1990s, the Government's policy objectives were to maintain the stability of the payment system but at the same time not to stifle innovation on payment products and services available to the public. It was also considered important to ensure that the payment obligations of card issuers, i.e. the value stored in the cards, could be honoured. On the basis of the above considerations, the Government decided that non-banks should be allowed to issue MPCs but they should be required to be authorized as a special-purpose vehicle deposit-taking company (DTC). The Banking Ordinance was amended in 1997 to this effect.

3. Under this policy, the HKMA authorised Octopus Cards Limited (OCL), the issuer of the Octopus Card as a DTC in 2000 and has been supervising it as such since then. The primary supervisory objective, in line with the Government's policy and the supervisory objective for all other authorised institutions, is to ensure the safety and soundness of the institution so as to protect the interests of cardholders, who are akin to depositors in the case of a deposit-taking entity.

Competition among MPCs in Hong Kong

4. The Government is generally supportive of the wider application of electronic money in Hong Kong. MPC schemes are one manifestation of electronic money.

5. A number of MPC schemes (e.g. Mondex and VisaCash) were introduced in Hong Kong some years ago but they turned out to be less popular than the Octopus Card and gradually faded out. As a result of natural market development, the Octopus Card remains now as the only MPC scheme in Hong

Kong.

6. It should be noted, however, that this market is open to all other potential operators and future competition by means of two routes: (a) under the Banking Ordinance, licensed banks are deemed to be approved to issue or facilitate the issue of MPCs; and (b) a non-banking institution may apply as a special-purpose vehicle whose principal business is to issue or facilitate the issue of MPCs and seek to become a deposit-taking company to conduct such business (OCL is an example using this route). The imposition of the same regulatory requirements on the existing and potential card issuers helps ensure a level playing field for market players.

7. In addition to regulatory requirements under the Banking Ordinance, OCL is also required to comply with the *Code of Practice for Multi-Purpose Stored Value Card Operation* which it voluntarily adopted in 2005 to enhance transparency and efficiency of its operation. Among other things, this Code specifically requires that there should be no measures having the effect of unfairly limiting competition in the market. There should also be no exclusive trading clause which prohibits merchants acquired by any operator from using other forms of stored value payment system. In addition, OCL should aim to share its technical platform with other parties interested in card issuing and merchant acquiring business after taking into account the security requirements and reasonable commercial considerations. This is to pave way for lowering the market entry barrier should another party be interested in issuing multi-purpose stored value cards in Hong Kong in the future. Although the Code is voluntarily adopted by OCL, it has been endorsed by the HKMA and the HKMA monitors OCL's compliance with it.

Informal oversight on EPS

8. Under the Clearing and Settlement Systems Ordinance, the HKMA is empowered to designate important payment systems and subject them to the oversight of the HKMA. Five systems¹, mainly wholesale interbank payment systems, have been designated since the enactment of the Ordinance in 2004. Although retail payment systems typically handle large numbers of transactions, these transactions are of relatively low value, and carry little, if any, systemic risk to the financial system. Therefore, a formal regulatory regime may not be justifiable. The HKMA has therefore formulated an informal oversight framework to promote the general safety and efficiency of the retail payment systems in Hong Kong.

¹ They are Hong Kong Dollar Clearing House Automated Transfer System, US Dollar Clearing House Automated Transfer System, Euro Clearing House Automated Transfer System, Central Moneymarkets Unit and Continuous Linked Settlement (CLS) System.

9. Under the informal oversight framework, the retail payment industry, including EPS Company (Hong Kong) Limited (EPSCO), is encouraged to draw up codes of practices and conduct self-compliance with such codes, while the HKMA oversees and monitors the overall implementation of this self-regulatory approach.

10. In December 2006, EPSCO together with seven other credit and debit card scheme operators² drew up and issued a *Code of Practice for Payment Card Scheme Operators* with the endorsement of the HKMA.

11. The Code, in general, sets out the safety, efficiency and oversight requirements on the card operators, including operational reliability, business continuity, network security, data integrity, operational efficiency, transparency, market access and governance arrangements.

12. EPSCO is required to conduct annual self-assessment of its compliance with the Code and submit the compliance report to the HKMA. In the event of non-compliance, the HKMA will follow up with EPSCO and encourage it to make rectifications.

HKMA's responses to the EPS add-value incident

13. After learning about the recent EPS add-value incident, in which the accounts of affected customers were debited although the relevant EPS add-value transactions were not completed, the HKMA took a number of actions aimed at protecting cardholders' interests. These actions include requiring OCL to conduct a thorough investigation into the root causes of the problem and arrange for prompt refunds to affected cardholders. Subsequently, OCL identified a total of 571 cases which they believed to have occurred after the communication network upgrade that took place on 5 December 2006. Refunds to the customers affected in these cases were completed on 14 February 2007.

14. On 16 February 2007, the Monetary Authority appointed Professor Chan Chi-fai, Chairman of the Hong Kong Deposit Protection Board and ex-Chairman of the Consumer Council, as an Advisor to OCL pursuant to section 52(1)(B) of the Banking Ordinance. This action was taken in the light of latest information revealed in a further inquiry conducted by OCL, at the request of the HKMA, that there were failed add-value transactions via EPS before 5 December 2006 in which the accounts of affected customers were debited although the relevant EPS add-value transactions were not completed.

² They are American Express International, Inc., China UnionPay Co. Ltd., Diners Club International (HK) Ltd., JCB International (Asia) Ltd., MasterCard International Inc., Visa International Service Association, Hong Kong Representative Office and Joint Electronic Teller Services Ltd. (JETCO).

15. On the same day, the HKMA also required OCL to commission an independent auditor under Section 59(2) of the Banking Ordinance to review the incident as well as broader issues such as the operational risk control environment of the company and for the auditors to submit to the HKMA a report on the review. Until the outcome of the independent review is available and the necessary enhancement measures have been implemented, the HKMA has required OCL to take steps to suspend, to the extent practicable, all add-value services through the EPS channel.

16. Separately, the HKMA is conducting an on-site examination to review whether any enhancements should be introduced for the existing operational and system procedures for handling add-value transactions through other means such as using cash or debiting customers' credit card accounts.

17. In the meantime, the HKMA has urged and OCL has agreed to: –

- review all relevant transactions and make refunds to customers proactively and without delay;
- disclose all relevant information to the public;
- keep the public informed of progress in addressing those issues.

18. The HKMA will continue to monitor the situation and ensure that cardholders' interests are protected.

Hong Kong Monetary Authority
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