

## Licensing

At the end of 2007, Hong Kong had 142 licensed banks, 29 restricted licence banks, 29 deposit-taking companies and 15 approved money brokers. In 2007, the Monetary Authority granted bank licences to seven foreign banks and authorized a transfer of the banking licence of a foreign bank. The Monetary Authority also granted certificates of approval to two money brokers. Three licensed banks, two restricted licence banks and four deposit-taking companies revoked their authorizations.

## PLANS FOR 2008 AND BEYOND

### Supervisory focus

#### *Credit risk management and asset quality*

The local and overseas economic outlook is uncertain given that the full impact of the US sub-prime crisis is still working its way through the global financial system. Tightening credit conditions coupled with the possibility of an economic slowdown in the US and a challenging business environment on the Mainland may have significant implications for the local economy and specific customers of Als. This could develop into a challenge for Hong Kong's Als in managing the associated credit risk amid intense market competition. The HKMA will monitor closely the asset quality of individual Als and assess the adequacy of their systems of internal controls for managing credit risks.

#### *China-related businesses*

The HKMA will continue to develop and promote supervisory strategies and policies to help ensure Hong Kong banks develop their China-related businesses in a prudent manner. Contact will be maintained with Mainland authorities to explore new business opportunities and improve cross-border supervisory co-operation. The HKMA will approach the Als regarding the proposed pilot scheme for Mainland residents to invest directly in listed securities in Hong Kong once details are available to ensure that they have adequate internal controls and operational capacity to cater for the new business.

### *Supervision of technology and operational risks*

#### *Internet banking, technology risk and business continuity management*

With the anticipated growth in on-line securities trading and Als' increasing dependence on technology, the HKMA will step up its supervision of Als' Internet banking and technology risk management. In particular, two rounds of thematic examinations are planned in 2008 to cover the system-capacity planning and contingency arrangements for on-line securities trading services, and the migration of the Real Time Gross Settlement and Central Moneymarkets Unit systems to the SWIFTNet infrastructure. In addition, detailed on-site examinations will be conducted for the development and support of systems related to Basel II. The HKMA will invite Als to perform supervisory control self-assessment on Internet banking, technology risk management and business continuity management. It also plans to work with the Hong Kong Association of Banks and the Hong Kong Police Force to develop an effective customer education programme in 2008 to promote sound control practices and awareness of emerging fraudulent techniques.

#### *Operational risk management*

Emerging operational risks of Als will be identified and addressed through specialist on-site examinations or off-site reviews, and an effective supervisory framework will be developed on high-risk areas, such as outsourcing arrangements.

#### *Supervision of securities and insurance businesses*

The HKMA will work with the SFC and the Insurance Authority on the supervision of Als' securities and insurance businesses, including the review of regulatory standards for the selling of investment-linked insurance products.

With the riskier nature of credit-linked investment products and the recent volatile market conditions, the HKMA will conduct thematic examinations of RIs' selling retail credit-linked investment products in 2008. Thematic examinations on the compliance monitoring of securities activities will be performed to ascertain whether RIs have sufficient controls to ensure their securities activities are conducted in compliance with legal and regulatory requirements.

### ***Supervision of treasury activities***

The HKMA will undertake a series of examinations in 2008 on the risk management practices and capabilities of selected AIs' treasury operations with regard to their investments in complex structured products. This is designed to identify and recommend sound industry practices for the AIs. The HKMA will also continue its specialised on-site examinations of AIs' treasury operations.

### ***Further specialisation of supervisory work***

Following a review of its supervisory process, the HKMA considers further specialisation in the supervision of selected risks and business areas of the banking sector will help improve supervisory efficiency in view of the growing complexity in banking operations. As a result, further specialisation in the supervision of commercial banking, consumer finance, wealth management and private banking will be implemented.

## **Basel II Implementation**

### ***Monitoring and assessment of impact***

The HKMA will monitor AIs' compliance with the revised capital adequacy framework and the impact of Basel II on AIs. For banks that have received approval to use the IRB approach, the HKMA will analyse their IRB data to assist the supervisory monitoring of their credit risk profile. To firm up the implementation strategy for other advanced approaches, such as those for the calculation of counterparty credit risk or operational risk, the HKMA will assess AIs' readiness for adopting

these approaches. It will also monitor the development of international standards by the Basel Committee, particularly in relation to the definition of capital base, securitisation framework and Pillar 2, and will consider incorporating appropriate changes to the capital adequacy framework, where necessary.

### ***Amendments to the Banking (Capital) Rules and Banking (Disclosure) Rules***

In the light of implementation experience and market events which occurred during 2007 (for example, the sub-prime crisis), the HKMA will review the need for amendments to the Banking (Capital) Rules and Banking (Disclosure) Rules. However, it is expected that amendments, if needed, will be mainly for refinement and clarification.

### ***Supervisory recognition for use of IRB approach***

In 2008, the recognition process will focus on AIs applying to adopt the IRB approach from 2009 to 2011. On-site examinations of AIs intending to adopt the IRB approach in 2009 have been scheduled and the HKMA will maintain regular dialogue with AIs planning to adopt the IRB approach in 2010 or 2011.

The HKMA will also conduct follow-up reviews of the approved IRB AIs to ensure that issues identified in the previous on-site examinations are fully addressed and appropriate refinements made to their internal rating systems.

### ***Supervisory review process***

Implementation of the SRP assessment framework in 2007 has provided valuable experience. The HKMA will identify areas where the framework can be further enhanced. AIs' compliance with the capital adequacy and risk management standards will be monitored and the need for more guidance to help them upgrade their existing systems will be considered.

### **Capital adequacy assessment process**

An important focus of the HKMA in 2008 will be to monitor AIs' progress in developing their CAAPs and evaluate their effectiveness. More guidance will be provided, if necessary, to assist the AIs in developing or improving their CAAPs to meet supervisory standards.

### **Review of the HKMA's work on banking stability**

The HKMA has commissioned a review on how best it can discharge its responsibilities in promoting banking stability. The review takes into account recent and likely future developments in Hong Kong's banking system and the changing nature of the risks, such as the globalisation of finance and banking business and the increasing integration of the financial systems of Hong Kong and Mainland China.

The review, being conducted by a consultant who is an expert on banking supervision both in Hong Kong and around the world, coincides with the end of the programme of banking sector reforms initiated in 1999.

The current review aims to make recommendations on the focus and priorities of the HKMA's banking supervisory functions in the next five years or so. Based on a combination of paper and statistical research and interviews with key stakeholders in Hong Kong's banking system, the review is expected to be completed in the second quarter of 2008. The HKMA will study the consultant's recommendations before deciding on a policy response.

### **Review of liquidity regime**

Market turmoil which emerged from the US sub-prime crisis in 2007 has clearly demonstrated the importance of liquidity risk management and supervision. The HKMA's supervisory framework on liquidity risk was last revised some years ago, which led to the issue of the SPM on "Liquidity Risk Management" in 2004. To ensure the supervisory framework remains appropriate to address recent market issues, the HKMA will review

its current liquidity regime in 2008, focusing on the following aspects:

- use of stress-testing and scenario analysis (with emphasis on market-wide stress scenarios) for liquidity risk management
- complex financial instruments and their implications for liquidity risk management
- management of contingent liquidity risk (including risks from off-balance sheet vehicles)
- effectiveness of banks' contingency funding plans
- adequacy of liquidity reporting requirements.

### **Development of supervisory policies**

Key policies and guidelines to be developed in 2008 include:

#### **Counterparty credit risk management**

This supervisory guideline will describe the approach to be adopted by the HKMA in supervising AIs' CCR and set out the main elements of an effective management system, having regard to applicable requirements under the Basel II framework, recommendations of the Counterparty Risk Management Policy Group, relevant supervisory requirements of other leading supervisors, and industry practices on CCR management.

#### **Internal audit and compliance functions**

The HKMA will provide guidance on its expectations for AIs' internal audit and compliance functions. Strong internal audit functions improve the effectiveness of risk management, control and governance. Adequate compliance acts as a "gatekeeper" to ensure AIs' conformity with rules, standards and procedures.

### **Consolidated supervision**

The HKMA practises a group-wide approach to supervision of Hong Kong-incorporated Als, where they form part of a financial group of companies, in line with the relevant standards contained in the *Basel Core Principles for Effective Banking Supervision*. The HKMA intends to prepare a supervisory guideline to outline its approach, requirements and practices to effect consolidated supervision of Als.

### **Prevention of money laundering and terrorist financing**

Hong Kong's AML and CFT supervisory framework will continue to be reviewed and updated in the light of developments, including the recommendations arising from the joint mutual evaluation by the FATF and the APG. The HKMA will undertake institution-specific and thematic examinations to ensure that Als remain vigilant in combating the problem, and will continue to develop the Industry Working Group to engage Als on relevant issues and proposals for practical guidelines for the industry.

### **Revised Basel Core Principles**

The HKMA is in the process of conducting a self-assessment of its compliance with the revised *Basel Core Principles* released by the Basel Committee in October 2006, focusing on the new key updates such as those on risk management and consolidated supervision, with a view to identifying areas for further improvement.

### **Consumer protection**

The HKMA will continue to promote industry self-regulation and improvement in the standards of banking practices through participation in the Code of Banking Practice Committee. It will assist the industry associations in completing the review of the *Code of Banking Practice* and monitor Als' compliance with the Code through regular self-assessments and the handling of complaints about banking services.

### **Deposit Protection Scheme**

The HKMA will continue to assist the Hong Kong Deposit Protection Board in operating the Deposit Protection Scheme. The Board will start implementing the various mechanisms developed in 2007 for monitoring Scheme members' compliance with the rules and guidelines of the Scheme. Enhancements will be made to the payout systems and processes in the light of the experience gained from the simulation tests and payout rehearsal. Further simulation tests and a payout rehearsal will be conducted to maintain and improve the Scheme's readiness. The Board will continue to promote the key features of the Scheme to the public through various promotional and educational channels.