

Responses to the questions raised in the letter of 8 October 2009

- (a) *How prevalent was the alleged practice of sending a representative of HKMA to the board meetings of local banks? What are the policy considerations underlying the alleged practice? What are the intended regulatory objectives to be achieved by such “attendance” at board meetings?*

Since 2000, the HKMA has adopted the practice of holding prudential meetings with the boards of directors of local banks once a year to the extent possible. This practice has become an important element of the HKMA’s supervisory process. The meetings provide an opportunity for the HKMA to share with a bank’s board of directors, among other things, the HKMA’s assessment of the bank’s performance and prudential concerns, if any. The meetings also serve as a formal and direct channel for the board to communicate with the HKMA. Bank directors have generally found such prudential meetings very useful to them in understanding the regulator’s assessment of the bank and the areas that the board should pay attention to. Regular meetings with banks’ boards of directors are a common practice among banking regulators in major overseas markets, such as the US and the UK.

However, it should be emphasised that holding regular prudential meetings with a bank’s board of directors does not mean that the HKMA attends or participates in the board’s own meetings, which are separate. It has never been the practice of the HKMA to send representatives to attend the board meetings of local banks or participate in the board’s discussions.

- (b) *What are the purposes for HKMA staff to express views on particular business activities or business decisions of a bank under his supervision (e.g. expressing concern about non-interest income not high enough)? Apart from commenting on the business activities or decisions of local banks, what initiatives or measures, if any, were taken by HKMA to encourage local banks to boost their non-interest income?*

The HKMA may provide a peer group comparison at its prudential meeting with a bank's board of directors in order to enable the board to understand the bank's position in the market. The analysis may show differences in the bank's financial position, including its sources of income, vis-a-vis its peers. In cases where a bank is found to have placed excessive reliance on a particular source of income, the HKMA will draw the board's attention to the potential risk of concentration. This said, what strategy a bank takes to address the potential risk of concentration is a commercial decision for its board. The HKMA has never directed a bank to pursue a particular business strategy.

- (c) *Did HKMA consider that as a result of the views expressed by HKMA staff (as asserted in the article), a bank might become more aggressive in non-interest income generating business activities, such as selling structured financial products? Did HKMA also take action to safeguard the interest of the investing public and ensure that banks would not expand such business without proper risk management?*

The HKMA considers that the diversification by banks into other lines of business such as securities and insurance is a result of the deregulation of the interest rates rules, which meant that banks could no longer rely to the same extent on interest income and gave them an incentive to reduce their revenue concentration risk by broadening their sources of income. The HKMA was aware of this development. The importance of proper risk management was repeatedly mentioned at the HKMA's meetings with banks' boards of directors.

The HKMA took steps to ensure that banks established effective risk management systems and internal control practices before they engaged in new lines of business. Whatever business banks intend to engage in, it is important that their management is able to ensure that all relevant legal and regulatory requirements are complied with. Insofar as the securities business of banks is concerned, such steps included taking part in establishing the existing regulatory framework for banks' securities business, and after the framework was implemented in 2003, issuing a series of guidelines and circulars specifying the standards that banks should observe in undertaking their securities activities. The HKMA ensured compliance with these guidelines and circulars through continuous off-site surveillance and on-site examinations. It also created an enforcement framework, modelled on that of the SFC, to handle cases of non-compliance with these standards. Details of the supervisory actions that the HKMA has taken to regulate the securities business of banks have been provided to the Subcommittee in some of our previous submissions.