

**Response to Further Follow-up Questions Raised by Hon Mrs Regina IP LAU
Suk-yea (letter of 11 February 2010 from the Clerk to the Subcommittee)**

1. I refer to HKMA's response to the follow-up question raised by me as conveyed in the letter dated 4 January 2010 from the Clerk to the Subcommittee (SC Ref. No. SC(1)-M41).

I note that HKMA explained in its reply that holding prudential meetings with the Board members of the local banks was one of the means adopted by the HKMA in carrying prudential supervision of the banks, and that it stepped up such supervision in the course of 2008, in the wake of the deteriorating sub-prime crisis in the US. Could the HKMA confirm that by "prudential" supervision of the banks, it was mainly concerned with such issues as capital adequacy, capital buffer, liquidity and leverage, i.e. the corporate soundness of the banks and their ability to "stay above the water"?

What about the increasing risks to investors who bought structured financial products such as the Lehman Minibonds and other Lehman-related products, e.g. equity-linked notes and other private placement notes, arising from the increasing risks of default of the parties and counterparties concerned, as the result of the worsening debt crisis in the US and Europe?

Did the HKMA sound any alarm to the local banks about the risks to their customers who bought structured financial products with exposure to the US sub-prime crisis? I note that between 2002 and 2008, sale of structured financial products increased significantly. In view of the much larger pool of investors and the rising risks, did HKMA advise the local banks to issue specific warnings to their customers about the escalating risk of default, and did HKMA ask the local banks to slow down their sale of such products?

As you know, Mr. Chairman, some local banks were selling Lehman-related products as late as in late August 2008 and allegedly even in early September 2008. Was HKMA aware of this and did they sound any warning to the local banks concerned in the course of their “prudential” meetings or through other means?

If the HKMA had done so, that is draw the attention of the banks to the rising risks of default of structured financial products and the attendant risks to their customers in 2007 and 2008, on how many occasions did the HKMA raise them?

Does HKMA agree that in 2007 and 2008, it was more concerned with risks to individual banks and the solvency of the banking sector as a whole than to the need for protection of the customers who bought structured financial products?

- 1.1 It is important to note that providing a reasonable level of investor protection is an integral part of the Hong Kong Monetary Authority’s (HKMA’s) overall supervisory framework of banks and is one of the key supervisory objectives of the HKMA as a prudential regulator. To ensure that all businesses of banks are adequately risk managed and conducted, the HKMA performs prudential supervision as well as conduct regulation of banks in its day-to-day supervisory process. As a result, prudential meetings with banks’ senior management or board members have not been restricted to discussions of matters relating to financial safety and soundness, but various facets of the internal controls and operations of banks, including their conduct of securities business, have also been discussed. For example, during the two-year period from 2007 to 2008, the HKMA held 37 prudential meetings with local banks’ senior management or board members¹, of which 22 meetings involved discussions of the banks’

¹ The 37 prudential meetings refer to 17 meetings with local banks’ senior management and 20 meetings with these banks’ board members.

internal controls over, and operations of, securities business. Moreover, having prudential meetings is only one of the means adopted by the HKMA in maintaining communications with local banks. In its day-to-day supervisory process, the HKMA also maintains close supervisory communications with the senior management and staff responsible for internal controls / compliance function of banks.

1.2 As pointed out in the response to Question 10 in Mr Joseph Yam's written statement submitted to the Subcommittee on 26 March 2009 (SC Ref. No. W6(C)), under the current regulatory framework, the policy objective of providing a reasonable level of investor protection is effected through requiring disclosure of the nature and risks of the product and an assessment by regulated intermediaries of the suitability of the product for the investor, so as to enable the investor to make an informed decision and take responsibility for it. As stated in the response to Question 1 in the said written statement of Mr Yam, in discharging its functions, the HKMA continuously assesses whether investors are adequately protected, given the changing market conditions and increasing participation of banks in securities business. According to this assessment, the HKMA has, since 2005, stepped up its regulatory efforts with regard to banks' selling of financial products, including undertaking more thematic on-site examinations of the sale of investment products by banks, issuing related circulars to the banking industry, and requiring large, complex or active registered institutions (RIs) to conduct independent self-assessment of regulatory compliance. Where incidents involving possible misconduct are identified in the day-to-day regulatory work, such cases are referred to the HKMA's securities enforcement team for appropriate actions.

1.3 RIs have obligation to comply with regulatory requirements on the disclosure of material information during selling process, product due diligence and customer suitability. While the HKMA was mindful that Hong Kong investors might be exposed to risks arising from the US sub-prime crisis and its knock-on effects, the HKMA was not in a position to issue warnings related to individual

institutions or specific products in view of the following:

- (a) As explained in paragraph 2 of the General Remarks section in Mr Yam's said written statement (SC Ref. No. W6(C)), during the first three quarters in 2008, at least 19 prominent financial institutions were reported to have experienced financial difficulties. It was extremely difficult, if not impossible, for anyone to predict whether any of these institutions would in fact fail or whether they would be taken over by another institution or rescued by a government. Before Lehman Brothers filed for bankruptcy protection on 14 September 2008, the prevailing market expectation, as shown by market indicators such as the credit default swap spread, was that some form of rescue or bail-out would take place, as had taken place with Bear Stearns and subsequently with AIG.
- (b) It would be inappropriate for any regulator to issue public warnings related to individual institutions or specific products (the reasons for which were explained in the response to Question 15 in Mr Yam's said written statement (SC Ref. No. W6(C))).

1.4 With regard to the fact that some local banks were selling Lehman-related products around late August / early September 2008, the HKMA was not aware of this fact at that time. The HKMA was not carrying out any specific on-site supervision action on these local banks during these two months and therefore did not become aware of these activities at the time that they were taking place.

1.5 Notwithstanding the above, the HKMA took various actions to give general warnings to alert the Hong Kong public (including banks and their customers) of the effects of the sub-prime problem and the risks of investments. The HKMA gave public warnings on a number of occasions as elaborated in the response to Question 15 in Mr Yam's said written statement (SC Ref. No. W6(C)). Moreover, as mentioned in the response to Question 11 in Mr Yam's said written statement (SC Ref. No. W6(C)), paragraph 8 of the General

Remarks section in Mr Y. K. Choi's written statement submitted to the Subcommittee on 14 May 2009 (SC Ref. No. W11(C)) and Mr Yam's response to item (c) of follow-up issues arising from the hearing on 14 April 2009 submitted to the Subcommittee on 23 April 2009 (SC Ref. No. M15), in view of the significant changes in market conditions arising from the sub-prime crisis, the HKMA has, since late 2007, devoted additional regulatory resources to retail credit-linked products, although this type of products only constituted a small proportion of the amount of structured products distributed by RIs at that time. After performing a survey covering major retail banks on retail credit-linked notes from December 2007 to early 2008 with the result that some RIs adopted a "high" risk rating classification, the HKMA advised those RIs that adopted a "medium" or "low" risk rating for these products to adopt a "high" risk rating classification for retail credit-linked products without full principal protection and recommend / introduce such products only to clients with high risk tolerance. In addition, the HKMA also conducted thematic examinations of RIs' selling of retail credit-linked investment products in 2008.

- 1.6 The HKMA is concerned about risks to individual banks and the general stability and effective working of the banking system as a whole as well as the need for protection of the customers who buy investment products from banks because all of these issues are related to the statutory functions of the HKMA. The HKMA always takes investor protection seriously, which is reflected by its on-going supervisory efforts, including off-site surveillance and on-site examinations of banks' securities business. As pointed out in the response to Question 2 in Mr Choi's said written statement (SC Ref. No. W11(C)), under the Banking Ordinance, the HKMA is required to take all reasonable steps to ensure that the banks operate in a responsible, honest and business-like manner. The HKMA is also required to take all reasonable steps to ensure that the banks' business (including their securities business) is conducted with integrity, prudence and the appropriate degree of professional competence.