

**Responses to Follow-up Issues Arising from the Hearing on 22 May 2009**

1. *With reference to Annex 2 of M20, between 2005 and mid-September 2008, whether any Registered Institutions (RIs) which had been rated “Green” (i.e. full compliance) by previous compliance self-assessments on regulated activities were subsequently downgraded to “Yellow” (partial compliance) or “Red” (failure to comply with any portion of the regulatory requirement or implement any alternative measures); and whether the Hong Kong Monetary Authority (HKMA) had referred any such RIs to SFC for consideration of sanction.*

1.1 As part of the compliance self-assessment process, the Hong Kong Monetary Authority (HKMA) analysed the self-assessment results submitted by the participating registered institutions (RIs), taking into account the areas which had been rated “Yellow” and “Red” and the nature of the issues identified, and classified the participating RIs into three categories:

- (a) “generally acceptable” rating for RIs for which the compliance self-assessment reports revealed that their internal control procedures appeared to be generally acceptable and effective;
- (b) “improvement required” rating for RIs for which the compliance self-assessment reports revealed possible isolated non-compliance with certain regulatory requirements; and
- (c) “unsatisfactory” rating for RIs for which the compliance self-assessment reports revealed possible control issues relating to compliance with certain regulatory requirements.

1.2 With reference to the summary results of the compliance self-assessments performed between 2005 and 2007 (Annex 2 of SC Ref. M20), 2 RIs had

been downgraded from the “generally acceptable” rating to the “unsatisfactory” rating by the HKMA during the period. Possible regulatory issues reported by these 2 RIs were referred to and investigated by the HKMA’s securities enforcement team. Following the investigations conducted by the HKMA’s securities enforcement team, the case of one RI was referred to the Securities and Futures Commission (SFC) for possible disciplinary action while the HKMA concluded that the other case did not raise any disciplinary concerns and the investigation report was copied to the SFC.

2. *The number of RIs which participated in compliance self-assessments on regulated activities in 2008.*

2.1 A total of 50 RIs participated in compliance self-assessments on regulated activities in 2008.

3. *Whether the large, complex and active RIs required by HKMA to conduct compliance self-assessments on regulated activities before mid-September 2008 included any or all of the 19 RIs involved in the sale of Minibonds and other Lehman Brothers (LB)-related structured financial products.*

3.1 All except one of the 19 RIs which sold Lehman Brothers (LB)-related Minibonds and structured financial products and were the subject of LB-related complaints participated in the conduct of compliance self-assessments on regulated activities from 2005 to 2008. The remaining RI participated in the compliance self-assessment process from 2007 to 2008. The RI was not invited to participate in the process previously as it was not large, complex or active in regulated activities taking into account the supervisory information available at the time.

4. *As revealed from HKMA's on-site examinations since April 2003, the minimum duration of time taken by the Relevant Individuals to adequately explain the nature and risks of structured financial products, including equity-linked notes and credit-linked notes, to their clients.*

4.1 Paragraph 5.3 (Know your client: derivative products) of the SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct") requires that a licensed or registered person providing services to a client in derivative products (including futures contracts or options, or any leveraged transaction) should assure itself, among other things, that the client understands the nature and risks of the products. The SFC's Questions and Answers on Suitability Obligations also provides that investment advisers should help each client make informed decisions by giving the client proper explanations of why recommended investment products are suitable for the client and the nature and extent of risks the investment products bear. In addition to explaining the good points of the investment products, investment advisers should always present balanced views, drawing the client's attention to the disadvantages and downside risks as well. Each client should also be given sufficient time to digest, consider and evaluate the information and recommendations provided by an investment adviser and be given sufficient opportunity to raise queries with the investment adviser. S1-Appendix 11

4.2 In practice, the duration of time required for clearly explaining the nature and risks of an investment product to a client by a Relevant Individual (ReI) varies depending on different factors including complexity of the product, and the client's knowledge and previous investment experience of products with similar features. Therefore, the HKMA and the SFC do not have a standard requirement for the minimum duration of time taken by ReIs to adequately explain the nature and risks of structured financial products to

their clients.

5. *To confirm whether HKMA's on-site examinations conducted before 2008 had detected any non-compliance on the part of RIs with the risk-disclosure requirements.*

5.1 As set out in Table 1 of paragraph 1.3 of my response dated 13 May 2009 to item (e) of the Subcommittee's information requests regarding follow-up to the hearing on 14 April 2009 (SC Ref. No. M20), the HKMA had conducted a total of 138 on-site examinations of RIs that covered, in whole or in part, the conduct of the securities business by RIs from April 2003 to December 2007. Through these on-site examinations, the HKMA identified cases involving 5 customers that were related to possible inadequate risk-disclosure on the part of RIs during the selling process. All these cases have already been referred to the HKMA's securities enforcement team for appropriate action.

6. *Regarding the conditions of settlement stipulated by certain RIs (e.g. withdrawal of complaints, agreement not to lodge further complaint against the RIs concerned, forfeiting the right to seek redress through court action or mediation), please advise:*
- (a) *the number of complaints that have been withdrawn by investors of Minibonds and other LB-related structured financial products since September 2008, and whether such withdrawal was made as a result of settlement with the RIs concerned;*
  - (b) *HKMA's views on the fairness or otherwise of settlement terms (similar to those set out above) being imposed by RIs, including any advice on the matter given by senior management (e.g. Executive Directors) of HKMA; and*
  - (c) *the legal opinions, if any, obtained by HKMA on whether the aforesaid conditions may be against public interest/policy.*

Item (a)

- 6.1.1 Up to 26 May 2009, a total of 1,553 LB-related complaint cases have been withdrawn by the complainants. According to the information provided by the relevant RIs and the complainants, there were 1,409 cases where voluntary settlements between the complainants and the relevant RIs have been reached. However, we do not have information on whether the withdrawal was made as a result of settlement with the RIs concerned.

Item (b)

- 6.2.1 Although the terms of voluntary settlement concerning complaints are something to be agreed between a RI and its customers, as set out in a circular ("Fair and reasonable arrangements for settling complaints related to



the selling of investment products”) (Annex 23 to SC Ref. W6(C)) issued by the HKMA on 5 March 2009, RIs should deal with all complaints honestly and fairly. Specifically, when a RI handles customers' complaints and discusses settlement arrangements with customers, it should ensure that, among other things:

- the process is conducted in a fair and reasonable manner; and
- the settlement agreement should not prohibit disclosure of information to the SFC, the HKMA or other law enforcement agencies for the purpose of any investigations.

6.2.2 If any RI does not follow such requirements, this may constitute a breach of General Principle GP1 (Honesty and fairness) of the SFC's Code of Conduct. **S1-Appendix 11**  
In addition, it should be emphasised that the HKMA's investigation into any case will not be closed on the grounds of a client's withdrawal of the relevant complaint. The HKMA will continue to gather information for the purpose of the investigation. Even if a complainant has withdrawn his/her complaint, the HKMA will still contact the complainant to request for assistance and provision of information, and also make all reasonable efforts to gather relevant information and evidence from other sources, such as records from the RI in order to continue the investigation. On the other hand, if the HKMA is aware of any RIs preventing any complainants from providing assistance in the investigation, it will take this matter seriously and review whether the RIs have breached the SFC's Code of Conduct.

#### Item (c)

6.3.1 Since the receipt of this request, I have sought legal advice from my in-house counsel on whether the conditions of settlement specified in this question are against public interest/policy.

6.3.2 I am advised that any contract including any settlement agreement between a complainant and a RI would not be enforceable if its terms are contrary to public interest/policy, such as if it deceives public authorities or purports to oust the jurisdiction of the courts. A party's promise not to seek redress through court action (i.e. forbearance to sue) in return for another party's promise to pay a sum of money is a valid consideration<sup>1</sup> under the law of contract and is not regarded as contrary to public policy. As such, the latter's payment obligation is enforceable as a matter of law.

6.3.3 I am further advised that none of the conditions that this question refers to prohibit the complainants from co-operating with, or disclosing information to, any regulator for the purpose of an investigation. Therefore, such conditions have not prevented the HKMA or the SFC from further investigating cases even though the complaints have been withdrawn by the complainants. The HKMA has continued to investigate these cases diligently by obtaining information from the complainants who decided to withdraw the complaints, the RIs concerned and other relevant parties. It is an offence for a person who, without reasonable excuse, fails to comply with a requirement imposed by the MA under section 180 of the Securities and Futures Ordinance (SFO).

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<sup>1</sup> Consideration is the price, detriment, or forbearance given as a value for a promise. To constitute a legally binding agreement, sufficient consideration is required.

7. *With reference to paragraph 3.1 of M21, the cost of the redeployment (either on a full-time or part-time basis) of HKMA permanent staff to assist the investigation into complaints in relation to RIs' sale of Minibonds and other LB-related structured financial products.*

7.1 As of 15 May 2009, the monthly staff cost of the HKMA's permanent staff who are deployed to assist with the investigation into complaints in relation to RIs' sale of Minibonds and other LB-related structured financial products is about HK\$ 2.3 million<sup>2</sup>.

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<sup>2</sup> Including the monthly staff cost (HK\$ 0.98 million) of the original permanent staff in the HKMA's securities enforcement teams and banking complaints unit.

8. The attached written questions raised by Mr LEUNG Kwok-hung and handed to the Monetary Authority at the hearing on 22 May 2009.

梁國雄議員要求澄清SFO, BO 及 MOU 的有關條款的法律問題

(May 22, 2009 文件一)

請澄清下列的法律問題:

1. 與 s55 BO 比較，s180 SFO 是否給予監管機構對 RIs/AIs 的監管及調查有更大的權力？請列出不同權力之處？
2. 根據 s56(2) BO，有關的 RIs/AIs 是否可運用「合理辯解」以拒絕遵守 s55 BO？何謂「合理辯解」？SFO 有沒有相類似的條款讓 RI 拒絕遵從 s180 SFO？
3. S180(11) SFO 規定，「有關當局可為施行本條(即 s180)以書面授權任何人為獲授權人」。請問金融管理專員的上述授權的權力，是否可從 s180(11)&(17)SFO 中獲得而不用取之於 BO，因 BO 並無相關條款？
4. s120(1)(a)BO 規定，「對於他在根據本條例行使任何職能時獲悉與任何人的事務有關的一切事宜，均須保密與協助保密」。若該等事宜及/或資料並非根據 BO 而取得，他是否可不受 s120 BO 約束？若受約束，原因何在？
5. 對監管機構在執行 s180 SFO 而從 RI 處獲悉的事宜，是否只受 s378 SFO 的保密條款約束而不受 s120 BO 約束？請解釋。

6. 保障投資者利益並不包括在 BO 中的 MA 職能規定內，而是放在 SFO 的 SFC 職能內，MOU 第 4 條指出 MOU 不能改變這方面的規定，若金管局就執行 MOU 條款上的各項分工上出現保障投資者不力的情況，金管局是否沒有任何法定的責任？證監會是否須對金管局的該等失誤負上最終責任？

7. 金管局總裁在他提供的 M17 para 10.2.6 中指出

*Although investor protection is not expressly stated in the BO, it is also a function of the HKMA that can be construed from the relevant provisions of BO.*

請金管局指出根據那些 BO 條款以 ‘construe’ ？

8. 為加快投資者對 RI 在有關結構性金融產品銷售的投訴，證監會是否可運用 SFO 及 MOU 第 4 條的規定，單方面通知金管局暫時擱置 MOU 的安排，以直接行使 SFO 所賦予證監會的權力，並在諮詢金管局後，對 RI 直接開立調查檔案，以加快調查進度？

#### Item 1

8.1.1 Section 180 of the SFO covers a wider range of persons than section 55 of the Banking Ordinance (BO). The main differences between section 55 of the BO and section 180 of the SFO are set out in Table 1 below:

**Table 1**

	<b>Section 55 of the BO</b>	<b>Section 180 of the SFO</b>
1. Exercising person	<p>The Monetary Authority (MA) (in respect of sections 55(1) and (2) of the BO)</p> <p>The Financial Secretary (in respect of section 55(3) of the BO and in relation to payment of expenses only)</p>	An “authorized person” (i.e., any person authorized by the MA or the SFC, as the case may be)
2. Persons who are subject to the relevant provisions	Any authorized institution (AI), in the case of an AI incorporated in Hong Kong, any local branch, local office, overseas branch, overseas representative office or subsidiary, whether in or outside Hong Kong, of such AI and approved money broker (in respect of section 55(1) of the BO)	Any intermediary (i.e., a licensed corporation or a RI), any associated entity of the intermediary, any related corporation of the intermediary or its associated entity, and <i>any other person</i> , whether or not connected with the intermediary or the associated entity (subject to the qualification referred to in item 3 below), as the case may be
3. Major powers that can be exercised under the relevant provisions	<p>May examine the books, accounts and transactions of any persons specified in item 2 above (section 55(1) of the BO)*</p> <p>Shall investigate the books, accounts and transactions of an AI if the requirements under section 55(2)(a) or (b) of the BO are satisfied (section 55(2) of the BO)</p>	<p>To enter the premises of the intermediary or its associated entity (section 180(1)(a) of the SFO)</p> <p>To inspect, make copies or otherwise record details of, any record or document relating to the business conducted by the intermediary or the associated entity; any transaction carried out by a related corporation of the intermediary or the associated entity; or any transaction or activity which was undertaken in the course of, or which may affect, the business conducted by the intermediary or the associated entity (section 180(1)(b) of the SFO)</p> <p>To make inquiries of the intermediary or associated entity; a related corporation of the intermediary or associated entity; or <i>any other person</i> (whom the authorized person has reasonable cause to believe has information relating to, or is in the possession of, any record or</p>

	Section 55 of the BO	Section 180 of the SFO
		<p>document referred to in section 180(1)(b) of the SFO) concerning any record or document referred to section 180(1)(b) of the SFO or any transaction or activity which was undertaken in the course of, or which may affect, the business conducted by the intermediary or the associated entity (section 180(1)(c) of the SFO)</p> <p>To require production of documents and explanations relating thereto (sections 180(3) and (4) of the SFO), to require the person giving any answer to verify the answer by statutory declaration (section 180(5)) and the person failing to give an answer for the reason that the answer is not within his knowledge to verify such reason by statutory declaration (section 180(6))</p>

- \* An AI is required by section 56 of the BO to afford the MA access to its books and accounts, documents, securities, cash and other information as the MA may require provided that such documents etc. shall not be required to be produced at such times and such places as shall interfere with the conduct of the normal daily business of the AI.

## Item 2

- 8.1.2 Section 56(2) of the BO provides that every director, every chief executive and every manager of an AI which, without reasonable excuse, contravenes section 56 of the BO (such contravention also includes a contravention by any of the AI's local branches, local offices, overseas branches, overseas representative offices or subsidiaries) commits an offence and is liable to a fine and to imprisonment.
- 8.1.3 Similarly, section 180(14) of the SFO provides that a person who, without reasonable excuse, fails to comply with a requirement imposed on him by an authorized person under section 180 commits an offence and is liable to a fine and to imprisonment.

8.1.4 The term “reasonable excuse” is not defined in the BO or the SFO. Whether a person has a reasonable excuse depends on the facts of individual case.

### Item 3

8.1.5 The authorized person referred to in section 180(1) of the SFO is the person authorized by the relevant authority pursuant to section 180(11) of the SFO and not the BO. The relevant authority means: (i) where the intermediary in question is a RI or the associated entity of a RI, the MA; or (ii) in any other case, the SFC (section 180(17) of the SFO).

### Item 4

8.1.6 Section 120(1)(a) of the BO provides that the MA and any other person to whom section 120(2) of the BO applies are required to preserve and aid in preserving secrecy with regard to all matters relating to the affairs of any person that may come to his or her knowledge in the exercise of any function under the BO unless one of the gateways under section 120 applies.

8.1.7 One of the key functions of the MA under section 7 of the BO is to take all reasonable steps to ensure that any banking business or any other 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. For the purpose of exercising these functions, the MA may use his powers under the BO and/or the SFO. For instance, the MA may use powers under sections 55, 56, 63(2) and/or 72A of the BO and/or section



180 of the SFO to obtain the necessary information during the examination or investigation process. Since all of this information is obtained by the MA in the exercise of his functions under the BO, such information is subject to section 120 of the BO, whether it is obtained under the MA's powers under the BO or the SFO.

#### Item 5

8.1.8 Please see my response to item 4 above on the applicability of section 120 of the BO to information obtained by the MA pursuant to section 180 of the SFO. In addition, the MA as a specified person is also obliged to observe the provisions of section 378 of the SFO in relation to information obtained pursuant to section 180 of the SFO. In other words, any information obtained under section 180 of the SFO is subject to both section 120 of the BO and section 378 of the SFO.

#### Item 6

8.1.9 With respect to whether the MA has a statutory duty to protect the interests of investors, please see my response to item 7 below and to questions 1 and 2 of item (j) of the Subcommittee's information requests (follow-up to the hearing on 17 April 2009) enclosed with the letter of the Clerk to the Subcommittee dated 20 April 2009 (SC Ref. No. M17).

8.1.10 The respective functions of the MA and the SFC are set out in the BO and the SFO. The SFC is not responsible for the MA's acts or omissions under the relevant provisions of the BO and the SFO. By the same token, the MA is not responsible for the SFC's acts or omissions under the relevant provisions of the SFO.

## Item 7

8.1.11 Please see my response to item 6 above as well as paragraph 2.2 of the written statement of Mr Y K Choi, JP, Deputy Chief Executive of the HKMA (SC Ref. No. W11(C)) which sets out the relevant sections of the BO from which the function of investor protection can be construed. In addition, the MA's functions listed in section 7(2)(a)-(d) of the BO are relevant to the protection of investors. Other provisions of the BO touching upon investor protection include sections 58A, 71C, 71E(6) and 132A(9).

## Item 8

8.1.12 Please see my response to item 7 under the heading “(May 22, 2009 文件 三)” below. The current procedure under the revised Memorandum of S1-Appendix 10 Understanding signed by the two regulators in December 2002 (MOU) has been streamlined to facilitate the SFC to carry out top-down investigation into the RIs which sold LB-related structured products.

8.1.13 The SFC has opened cases for investigating all the RIs which sold LB-related investment product under section 182(1)(e) of the SFO and consulted the MA under paragraph 9.2 of the MOU on the terms of the investigation. The MA has provided his comments at short notice to enable the SFC to conduct the investigation expeditiously.

## 梁國雄議員跟進金管局文件 M17 及 M19 的提問

(May 22, 2009 文件二)

就前線審查 RI 的 SFO 受規管活動，請提供下述資料：

1. 就金管局提交的 M17(April 17, 09) 文件，請金管局在 Annex 3 內信貸掛勾投資中的 52 個違規銷售個案，分別列出二月及三月各佔的個案數量。為何 4 至 6 月停了，到 7 月才再查第 4 間銀行？為何 8 及 9 月又停下來？
2. 在 M19 para. 6.2.3 中，HKMA 提及用 risk-based approach 作抽查，請提供這個 approach 的詳細資料？
3. 在執行對 RIs 的現場審查中，金管局對選擇產品的 selection criteria 是什麼？請列出所有這方面的 criteria。(M19 para 6.2.3 已列出三種)。
4. 請提供在三個不同 tiers 的現場審查中、審查員需要填寫的各種表格、報告的格式、及各單項的評審標準。
5. 審查員有沒有前線審查的 handbook 或類似的文件？有則請提供。
6. 金管局在前線審查時，有否將《操守準則》的 s2.3 (有關廣告)、s3.4 (透徹的分析建議)、s5.2 (適合性及相關的 FAQs)、s5.3 (確保客戶明白衍生工具的性質及風險) 的 compliance 作特別分類審查？(M19 para 6.2.3 的答案太籠統，請對上述四方面逐一作答，因這四方面的投訴不少)。
7. 在 M19 para 6.2.9 指出 'non-compliance issues' 是交給 RI 高級管理層去作出改善。為何對 'non-compliance' 不用跟進處罰，而讓 RI 改善即可。這些 'non-compliance' 是那方面的 'non-compliance'？請列出。

## Item 1

8.2.1 As set out in Annex 3 to my response dated 27 April 2009 to item (d) of the Subcommittee's information requests regarding follow-up to the hearing on 17 April 2009 (SC Ref. No. M17), the HKMA conducted a round of thematic examinations of the investment advisory and dealing activities involving retail credit-linked investment products ("retail CLN thematic examinations") in 2008. Before the collapse of LB, the HKMA completed the field work of the examinations of 4 RIs although the HKMA continued to seek additional information from the RIs in relation to the findings of examinations after the field work. As a result, suspected mis-selling cases involving 52 customers were identified and these cases were referred to the HKMA's securities enforcement team in batches for appropriate action from July 2008 to March 2009.

8.2.2 It should be pointed out that an on-site examination process involves a number of key stages, including commencement of the examination, performance of field work, completion of field work, follow-up of outstanding issues, issue of the examination report, agreeing and following-up on RIs' planned actions, and referral of any possible misconduct cases to the HKMA's enforcement team. Therefore, contrary to what was indicated in the question, the process of the retail CLN thematic examinations had not been stopped before mid-September 2008. Although no new examination was initiated and no further field work was conducted after the collapse of LB, the follow-up work of the examinations continued until March 2009.

### Items 2 and 3

- 8.2.3 As explained in the HKMA's Supervisory Policy Manual module SA-1 entitled "Risk-based Supervisory Approach" (see Annex 1), a risk-based supervisory approach, which emphasises effective planning and examiner judgement, customises examinations to suit the size and activities of AIs and to concentrate examiner resources on areas that expose the AI concerned to the greatest degree of risk.
- 8.2.4 As set out in paragraph 6.2.3 of my response dated 12 May 2009 to question 2 of item (f) of the Subcommittee's information requests regarding follow-up to the hearing on 8 May 2009 (SC Ref. No. M19), when selecting a sample of securities-related transactions conducted by the examined RIs for review during on-site examinations, the HKMA adopts a risk-based approach in determining what investment products to be selected, based on criteria such as the popularity of the investment product (i.e. high sales volume), the number of customer complaints about possible mis-selling of the product, the sales commission attached to the product and other criteria such as transactions with vulnerable customers.

### Items 4 and 5

- 8.2.5 For items 4 and 5, I would make a separate submission to the Subcommittee.

### Item 6

- 8.2.6 The scope of a typical on-site examination of a RI's selling practices covers the relevant requirements of the SFC's Code of Conduct, including paragraphs 2.3 (Advertising), 3.4 (Advice to clients: due skill, care and

diligence), 5.2 (Know your client: reasonable advice) and 5.3 (Know your client: derivative products).

#### Item 7

- 8.2.7 As a normal practice, where non-compliance issues identified in an on-site examination reveal possible misconduct or breach of the relevant legal or regulatory requirements, the incidents are referred to the HKMA's securities enforcement team for investigation and disciplinary proceedings or referral to the SFC as appropriate. At the same time, the RI examined is required to take actions to rectify the issues identified and strengthen the related internal controls to prevent the issues from happening again.
- 8.2.8 If the non-compliance issues identified do not indicate any possible misconduct but require further enhancements to RIs' internal control system, the RI's senior management will be required to take prompt corrective actions. For instance, the non-compliance issue may involve a breach of the examined RI's internal policies and procedures such as late replies given to some of the complainants, no regular reviews of ReIs' information in the HKMA register and inactive distribution of the SFC's education leaflets.

梁國雄向金融管理專員任志剛先生的提問

(文件三)

(2009年5月22日)

A. 有關CDS的性質是保險產品的問題

1. 任專員，你或你的前線監管同事是否全部都沒有保險承保業 (insurance underwriting industry) 的專業資格呢？
2. 任專員，你在上次的發言中亦承認了雷曼債券是一種保險產品，只不過提供保險的是雷曼苦主，你應該知道，他們是在一無所知的情況下成為業餘保險公司，並且只承保小量的保單。對嗎？
3. 相信銀行的銷售員，亦不很了解「保險單」的承保人若只是業餘地經營，並只承包小量的保單的風險，是非常、非常高的事實吧。對嗎？
4. 什麼是保險產品的風險，我這裏有一份由澳洲最大的保險承保人 IAG，根據澳洲監管機構 APRA (Australian Prudential Regulation Authority) 的要求，作出的保險產品的風險報告，你可以用作參考。其列出13種 underwriter 的風險而 concentration risk 是一個重要的風險。

金管局有沒有審查銀行銷售員對保險單的各種風險的知識呢？

我將會要求立法會傳召專家，幫助公眾了解雷曼債券的風險性質，以對香港金融監管，特別是銀行出售這類產品的監管，作出改善。

## Part A

### Items 1, 2, 3 and 4

- 8.3.1 It is important to note that, while I drew an analogy between Credit Default Swap (CDS) and insurance to explain the nature of risk (i.e. default) and reward (i.e. premium), it is inappropriate to over-extend the analogy by likening a credit-linked note (CLN) holder to an “amateur insurer” and applying a different set of standards. In fact, LB-related Minibonds were a fully pre-funded investment that was bundled with CDS, and therefore they exhibited a nature very different from that of insurance.
- 8.3.2 We consider it both logically inappropriate and conceptually incorrect to liken a LB-related Minibonds holder to an “amateur insurance company”. The HKMA therefore does not expect bank staff selling LB-related Minibonds (or other similarly structured CLNs) to explain the risks of insurance underwriting when they introduce such products to their customers. For the same rationale, in reviewing the selling practices of CLNs, the HKMA’s supervisory staff have not examined the knowledge of the relevant sales staff of RIs in the risks of insurance underwriting.
- 8.3.3 In general, the staff in the HKMA’s Banking Supervision Department do not have and are not required to have professional qualifications in insurance underwriting. As explained in paragraphs 8.3.1 to 8.3.2 above, such qualifications are not relevant to the supervision of RIs’ selling of CLNs.



## B. 關於金管局對CDS的風險早已確認的問題

請聽清楚我提供的下述資料，並回答我的問題：

你一直說，信貸違約掉期(CDS)不是高風險產品，直到2007年底，當發覺CDO產品有價無市，才將含有CDO及CDS的產品的風險提高，才意認到要針對這些產品，做專題審查。

但根據我手上的資料並非如此，金管局2001年的「Supervisory Policy Manual」(VI-29.06.01)已要求銀行加強對CDS及CLN的「信貸衍生產品」(即 credit derivatives)的風險管理，並要求銀行的管理層，「若沒有能力去理解及管理這些產品的信貸及其相應的風險，則不要購買或出售這些產品」。「並要為這些產品的經營，建立相應的風險管理、程序、及內部監管機制」。

在2003年，你的下屬亦撰文指出「信貸衍生產品」的槓桿比率非常高，會為全球金融帶來動盪(報告上次已給了你)。他們亦引述格林斯潘於2002年對「信貸衍生產品」的警告演詞(一并給你參考)，以支持他們的分析。

以上的事實證明，你及你的金管局同事的確是先知先覺地，並在遠至2001年，已明白這種產品的風險，並對銀行的業務安全性採取了相應措施。但對銀行售賣此種產品給投資者的專題審查，則一直延至08年2月才做，引致今天有成千上萬的苦主。

另外，即使到了2007年底及08年2至3月，當CDO已是有價無市時，金管局雖對3家銀行就產品進行了專題審查，並發現了大批懷疑違規銷售個案(30-50單)，但仍無對違規銀行採取緊急措施，阻止雷曼債券的銷售，或請求證監會協助，共同平衡審查餘下已抽選的8間銀行，因而導致更多人受害。這便可能構成「罔顧實情而不積極行動，以阻止違規銀行對存戶及投資者作出傷害」

的「失職錯誤」。

我的問題是：

5. 你能否解釋，為何你有上述的表現呢？
6. 你既然聲稱調查人手不足，為什麼在雷曼事件前後直至現在，也不要求證監會提供幫助，由他們用 SFO s180 提供人手，直接參與當時急需的前線審查及現時違規的投訴以加快進度，減低事件對特區金融中心聲譽的破壞，及減少受銀行違規所害的人的痛苦？
7. 如果證監會主動要求提出幫助，你有沒有法律權力阻止呢？根據那一條例、那一款？

## Part B

### Item 5

8.3.4 The question is based on a wrong foundation and I disagree with this foundation as the Supervisory Policy Manual module CR-G-12 “Credit Derivatives” and the research paper of “Credit Risk Transfer Using Derivatives and Implications for Financial Market Functioning” were not focused on issues relating to retail investors. For reasons explained below, the contents of these two documents should not be interpreted as equally applicable to retail investors of CLNs with CDS embedded.

M24

8.3.5 The Supervisory Policy Manual module CR-G-12, which was issued by the HKMA in June 2001, applies to AIs (including all RIs) which use credit derivatives including CDS and CLN to manage risk or enhance income

through arbitrage between different markets. This module however was not any “risk warning” to AIs on credit derivatives. Instead, the risk management measures recommended in this module generally reflect the risk management infrastructure that the HKMA expects AIs to have in place across different lines of business. The specific requirements set out in the module, including those on risk management, are intended for and relevant to RIs as professional and institutions acting as buyers or sellers of credit protection on a portfolio basis. Similarly, the research paper of “Credit Risk Transfer Using Derivatives and Implications for Financial Market Functioning” issued by the HKMA in December 2003 focused on financial institutions and the implications of the credit derivatives on financial markets and financial stability.

8.3.6 Apart from the supervision of AIs’ risk management in relation to their proprietary investments, the HKMA has also focussed on the protection of investors through its regulation of RIs’ conduct of regulated activities, particularly RIs’ selling of investment products (including structured products). The HKMA’s regulatory efforts include:

- issuing supplementary guidance or requirements in the form of circulars to RIs (15 circulars issued from 2003 to September 2008);
- undertaking securities-related on-site examinations (170 examinations conducted during April 2003 to 31 December 2008, including 85 thematic examinations between 2005 and 2008 which reviewed RIs’ sale practices related to investment products); and
- since 2005 requiring large, complex RIs or RIs which are active in conducting regulated activities (including all active retail banks) to conduct independent self-assessment of their compliance with regulatory requirements.

Where the day-to-day regulatory process or any complaint received reveals possible misconduct, the incident is referred to the HKMA’s securities

enforcement team for investigation and disciplinary proceedings or referral to the SFC as appropriate.

8.3.7 Turning to the timing of conducting retail CLN thematic examinations, the selection of themes for securities-related thematic examinations depends on the supervisory information available and the prevailing market conditions at the time of planning supervisory work. In the past few years, CLNs only represented a small portion of structured products sold to retail customers by retail banks<sup>3</sup>. Regarding the number of complaint cases, there had been only a few complaint cases relating to the possible mis-selling of CLNs received by the HKMA prior to the collapse of LB<sup>4</sup>.

8.3.8 Notwithstanding the small market share and small number of complaint cases reported on the sale of credit-linked products, in late 2007, the HKMA decided to conduct a round of retail CLN thematic examinations in 2008.

#### Item 6

8.3.9 Before the collapse of LB, the HKMA completed the field work of 4 retail CLN thematic examinations. The supervisory information available to the HKMA as at the time of the collapse of LB only revealed possible mis-selling in one of the selling units of one RI, in relation to which suspected mis-selling cases involving 37 customers had been referred to the HKMA's securities enforcement team. The HKMA had also ensured that the RI concerned took immediate actions to suspend the function of selling securities products of the ReIs involved. With respect to the other 3 thematic examinations on the selling of retail CLNs, one of the examinations

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<sup>3</sup> For example, between 2007 and 2008, CLNs only accounted for approximately 1% of the total nominal amount of structured financial products sold by retail banks to retail customers.

<sup>4</sup> From April 2003 until 14 September 2008, the HKMA had received 5 complaint cases relating to suspected mis-selling of CLNs (including 2 complaint cases involving LB-related Minibonds). From the survey on the distribution of retail CLNs by retail banks conducted in late 2007 with the 16 selected RIs, it was noted that there were only 2 complaint cases relating to the sale of credit-linked products received by the selected RIs between 2006 and 2007.


did not reveal any suspected mis-selling case. Regarding the other 2 thematic examinations, at the time of the collapse of LB, the HKMA was seeking additional information from the RIs in relation to the findings of examinations. As a result, another 15 customers' cases were identified and referred to the HKMA's enforcement team for appropriate action after the collapse of LB. Based on the available supervisory information in mid September 2008, it was pre-mature for the HKMA to establish whether there was any potential industry-wide problem of possible mis-selling, and whether there was a need to seek assistance from the SFC.

8.3.10 After the collapse of LB, due to the huge amount of complaints, the SFC considered that a "top-down" investigatory approach could enable it to respond quickly to the maximum number of complaints in the shortest possible time. In October 2008, the SFC and the HKMA agreed on a set of procedures to deal with the large number of complaints and to facilitate the SFC's "top-down" investigations. Under these procedures, the HKMA refers to the SFC those cases which the HKMA has found prima facie evidence for referral during its preliminary investigation for the SFC to conduct "top-down" investigation into the RIs concerned. Using this approach, as the HKMA understands it, the SFC has opened investigation into all of the retail banks selling LB-related investment products. There have been regular reviews of such approach by the two regulators and so far, both the SFC and the HKMA consider that the referral arrangement remains efficient and should be continued. Moreover, the HKMA has been recruiting additional staff to handle LB-related complaints.

#### Item 7

8.3.11 As mentioned in paragraph 8.3.10 above, the SFC and the HKMA have streamlined the procedure for handling LB-related complaints. There is no question of the HKMA forbidding the SFC from conducting investigation

into the RIs. On the contrary, the HKMA has been working hand in hand with the SFC to facilitate its top-down investigation in order to expedite the investigation process in the interests of the investing public.

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This module should be read in conjunction with the [Introduction](#) and with the [Glossary](#), which contains an explanation of abbreviations and other terms used in this Manual. If reading on-line, click on blue underlined headings to activate hyperlinks to the relevant module.

## **Purpose**

To explain the HKMA's risk-based supervisory approach

## **Classification**

A non-statutory guideline issued by the MA as a guidance note

## **Previous guidelines superseded**

This is a new guideline.

## **Application**

To all AIs

## **Structure**

1. Supervisory framework
  - 1.1 Introduction
  - 1.2 Key benefits
  - 1.3 Integration with CAMEL rating system
  - 1.4 Risk-based approach and methodology
  - 1.5 Risk assessment
  - 1.6 Supervisory process
  - 1.7 Primary prudential obligations of an AI
2. The eight types of inherent risk
  - 2.1 Credit risk
  - 2.2 Market risk
  - 2.3 Interest rate risk



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- 2.4 Liquidity risk
- 2.5 Operational risk
- 2.6 Reputation risk
- 2.7 Legal risk
- 2.8 Strategic risk
- 3. Four elements of a sound risk management system
  - 3.1 Summary
  - 3.2 Board and senior management oversight
  - 3.3 Policies, procedures and limit structure
  - 3.4 Risk measurement, monitoring and management reporting systems
  - 3.5 Internal controls and comprehensive audits
- 4. Rating risk management
  - 4.1 Factors considered
  - 4.2 Rating scale and integration into CAMEL rating
  - 4.3 Definitions of risk management ratings

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## 1. Supervisory framework

### 1.1 Introduction

- 1.1.1 The objective of the supervisory framework of the HKMA is to provide an effective process to monitor and assess the safety and soundness of AIs on a continuing basis. The process follows a risk-based approach. It consists of a structured methodology designed to establish a forward-looking view on the risk profile of AIs. This permits a direct and specific focus on the areas of greatest risk to an AI. It also enables the HKMA to be more proactive and better positioned to pre-empt any serious threat to the stability of the banking system from any current or emerging risks.





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1.1.2 This enhanced risk-based supervisory approach has been implemented by the HKMA in response to a recommendation in the Hong Kong Banking Sector Consultancy Study, completed in December 1998. The recommendation was based in part on a perceived need to raise the supervisory process to a more effective level by addressing the risks and increasing competition within the market place.

1.1.3 The adoption of a more risk-based framework is designed to allow the HKMA to continue to deliver consistent, high-quality supervision as the banking sector develops and risk profiles of AIs change in reaction to competitive forces. The enhanced supervisory regime will complement regulatory changes to promote both competition and the safety and soundness of the banking sector. This approach should benefit AIs as the regulatory effort is more focused on high-risk areas and provides for more efficient supervision.

## 1.2 Key benefits

1.2.1 The key benefits for both the HKMA and AIs from this enhanced supervisory framework are:

- better evaluation of risks through separate assessment of inherent risks and risk management processes;
- greater emphasis on early identification of emerging risks at individual AIs and on a sector-wide basis;
- cost-effective use of resources through a sharper focus on risk, which in time should result in examination teams spending less time on site at individual AIs;
- more utilisation by the HKMA of management information prepared by AIs;
- a better appreciation by supervisors of the management quality of AIs, the characteristics of their business and the risks they face;



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- enhanced value of the supervisory work performed to both the management of AIs and the supervisors, who have a common interest in ensuring that risks are properly identified and that adequate and effective control systems are established to monitor and control risks; and
- cost of supervision, in terms of management time of an AI, will be more directly related to the AI's risk profile, i.e. the intensity of supervision and the amount and focus of supervisory action will increase or decrease in line with the perceived risk profile of the AI.

### 1.3 Integration with CAMEL rating system

- 1.3.1 The CAMEL<sup>1</sup> rating system, which has been implemented at the HKMA since 1995, is designed to assess in a comprehensive manner an AI's financial condition, compliance with laws and regulations, risk management systems and overall operating soundness. Its primary purpose is to help identify those AIs where weaknesses in the aforementioned areas require special supervisory attention or warrant a higher than normal degree of supervisory concern.
- 1.3.2 Risk-based supervision is a dynamic and forward-looking approach, which provides the supervisory process with the necessary framework to factor the risk profile of an AI into the CAMEL rating system. Risk-taking has always been present in the banking business, and rightfully so, but has increased significantly, primarily due to the need to remain competitive in a fast-paced environment.
- 1.3.3 The risk-based methodology incorporates the risk profile, which is ascertained by balancing the level of inherent risk with the quality of risk management systems at AIs, into the CAMEL rating system. Each of the CAMEL components is, as shown in the following diagram,

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<sup>1</sup> CAMEL is an internationally recognised framework for assessing Capital adequacy, Asset quality, Management, Earnings and Liquidity. The overall rating is expressed through the use of a numerical scale of 1 to 5 in ascending order of supervisory concern.



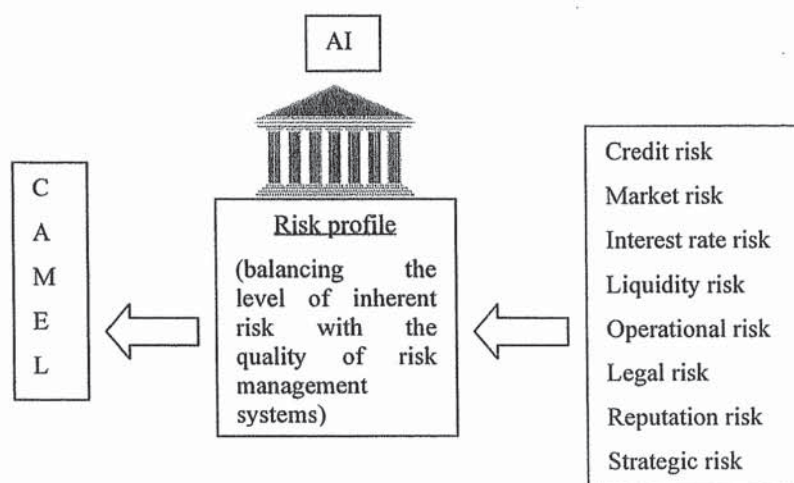
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affected by one or more of the eight inherent risks (credit, market, interest rate, liquidity, operational, legal, reputation and strategic), which the HKMA has identified as risks to be assessed during the supervisory process. These eight inherent risks are described in section 2 below.



- 1.3.4 Under the risk-based approach, a change in the CAMEL rating of an AI may result from the qualitative analysis of its risk profile in addition to the more traditional quantitative analysis of its financial data. An example of such a change would be a down-grade in asset quality to a "3" for an AI which displays current indicators representing an asset quality of "2" but whose credit risk, as a result of recent aggressive lending practices and less than satisfactory credit risk management systems, has been assessed as high.
- 1.3.5 This approach to supervision does not eliminate or change the quantitative approach to assessing the components of the CAMEL rating system but it adds a new dimension, which enables the supervisory process to inject more judgement, based on a forward perspective, in arriving at a final rating.
- 1.3.6 The risk-focused examination process places more emphasis on an evaluation of the quality of risk management systems and internal controls. A risk



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management rating is assigned at the conclusion of the on-site examination by the on-site manager to the AI and formally incorporated into the management component of the CAMEL rating. It may also influence the ratings given to the other CAMEL components, as illustrated in para. 1.3.4 above. Section 3 below gives details of the four elements of a sound risk management system and section 4 describes the risk management rating system.

**1.4 Risk-based approach and methodology**

- 1.4.1 The risk-based supervisory approach, which emphasises effective planning and examiner judgement, customises examinations to suit the size and activities of AIs and to concentrate examiner resources on areas that expose the AI concerned to the greatest degree of risk.
- 1.4.2 The risk-based methodology, shown in the diagram below, consists of six key steps, each of which requires the preparation of specific documentation.

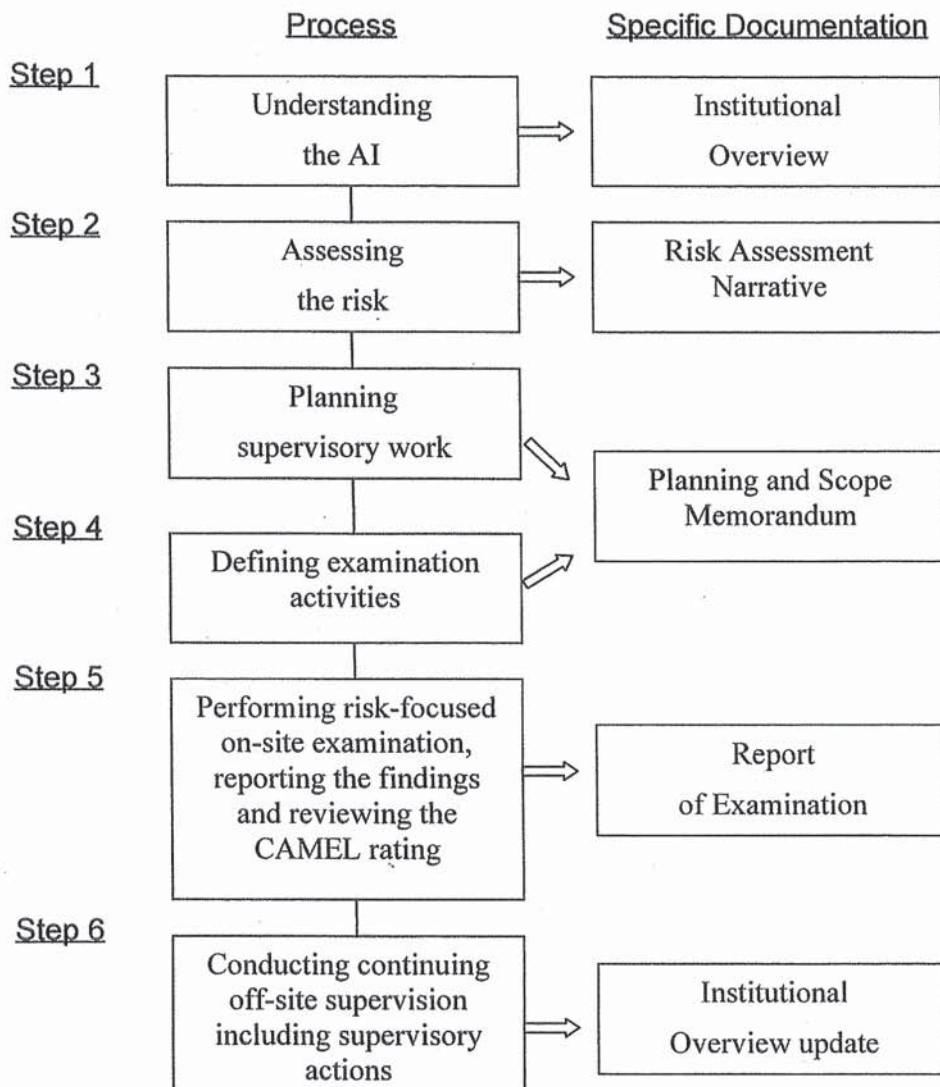


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1.4.3 The first step in the risk-based methodology, Understanding the AI, requires the preparation of an Institutional Overview document.

1.4.4 The Institutional Overview provides a concise portrait of an AI's structure and financial condition. It summarises key business lines and functions, the business strategy and any planned introduction of new products, describes legal structure and financial condition and identifies problem issues related to the AI itself or its affiliated



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entities, such as domestic or foreign subsidiaries and branches.

- 1.4.5 Information provided in the Institutional Overview is determined by the complexity of the AI and is primarily based upon internal and public sources of data, as well as information gathered from periodic on-site visitations.
- 1.4.6 The second step in the risk-based methodology, Assessing the Risk, results in the completion of a Risk Assessment Narrative.
- 1.4.7 The risk assessment exercise is designed to identify the type, level and direction of risks of an AI.
- 1.4.8 In order to conduct this exercise effectively, a building-block approach is used in which each of the significant activities of the AI is assessed with respect to the level of each of the inherent risks and the risk management systems in place to manage these risks.
- 1.4.9 The objective of the risk assessment exercise is to develop a comprehensive risk profile, which captures all the eight types of inherent risks of the AI. Subsection 1.5 below describes the risk assessment process in more detail.
- 1.4.10 The risk profile is used to complete the third and fourth steps in the risk-based methodology, which are Planning the Supervisory Work and Defining Examination Activities. The document to be prepared for these two steps is the Planning and Scope Memorandum. The HKMA will try to customise examination tasks so that they are consistent with the complexity and risk profile of the AI.
- 1.4.11 The emphasis of the risk-focused examination to be performed in step five is on evaluating the effectiveness of the risk management system of the AI for each type of inherent risks. At the conclusion of the on-site examination, as previously indicated in para. 1.3.6, a risk management rating is assigned by the on-site manager and factored into the management component of the CAMEL rating. The risk management rating may also affect the rating for one or more of the other CAMEL



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components. A report of examination will then be produced in this step to capture the examination findings and results from the review of the CAMEL rating.

- 1.4.12 As the risk-based supervisory methodology revolves around a process of continuing off-site supervision, the Institutional Overview produced in step one will be constantly updated throughout the year in step six, making it a dynamic document which always reflects the most current position of the AI.

### 1.5 Risk assessment

- 1.5.1 The development of a formal risk assessment process represents an important addition to the HKMA's supervisory approach. The purpose of this risk assessment undertaking is, as indicated earlier, to identify the type, level and direction of all significant risks of an AI. The process consists of determining the level of risk in each of the eight inherent risks by business activity, the direction of risk, the adequacy of existing risk management systems and the impact, if any, of external risk factors. It concludes with a composite risk level for each business activity and an overall risk profile for the AI.
- 1.5.2 The level of inherent risk is defined as the probability and degree of potential loss due to an adverse event or action within a particular activity or product without regard to the adequacy and quality of the relevant risk management system in place. Ascertaining the level of inherent risk is a judgement call after assessing and weighing all the factors and evaluation criteria for each of the inherent risks. For example, if the asset quality of the loan portfolio being assessed has deteriorated to a less than satisfactory rating with a high level of classified credits, the level of inherent credit risk will probably be rated as high.
- 1.5.3 The adequacy of risk management systems is determined by evaluating the four elements of a sound risk management system as follows:
- active Board and senior management oversight;



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- effective organisational policies, procedures and limits for managing business activities;
- adequate risk measurement, monitoring and management reporting systems; and
- comprehensive internal controls, including an effective internal audit function.

1.5.4 The following eight inherent risks which have been identified by the HKMA are to be assessed during this process:

- credit;
- market;
- interest rate;
- liquidity;
- operational;
- legal;
- reputation; and
- strategic.





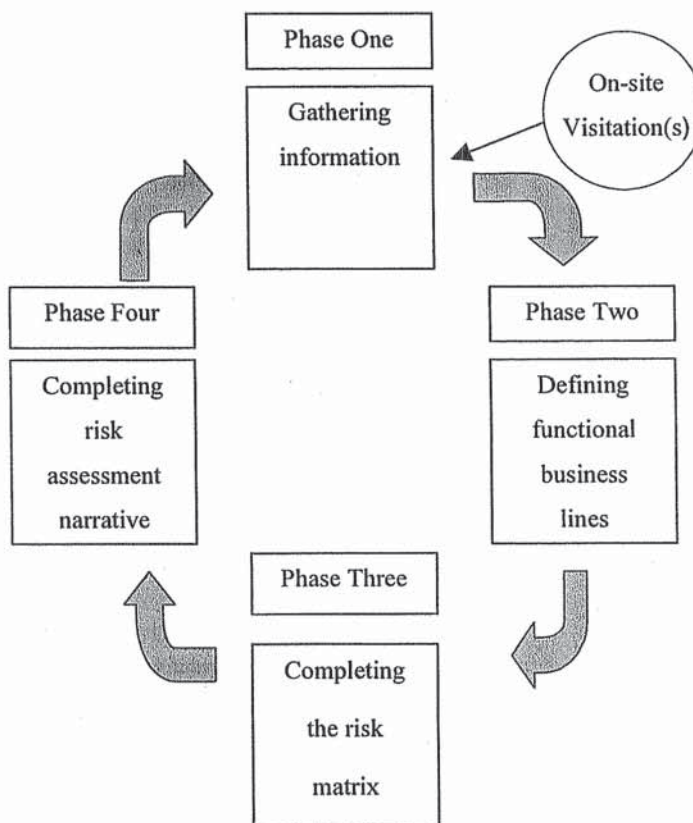
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1.5.5 The risk assessment exercise consists of four phases as shown in the following diagram:



1.5.6 In phase one, sufficient information must be gathered to understand fully the business activities and risk management systems of the AI. This is often accomplished by conducting one or more on-site visitations to the AI to obtain the required information or to clarify information already received.

1.5.7 In phase two, functional business lines and the relative significance of activities are properly identified. In identifying functional businesses, the HKMA will adopt as far as possible the AI's own classification of its different businesses, since the internal management information reports are likely to be compiled on the same basis. Use of the AI's own classification will usually facilitate the HKMA's analysis and assessment.



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- 1.5.8 There are four steps involved in phase three. The initial step is to identify the level of inherent risk by functional activity for each of the eight inherent risks. The level of inherent risk, which is a judgement call by the case officer, can be assessed as "high", "moderate" or "low". Qualitative as well as quantitative factors will be considered for each functional activity in arriving at the judgement. Generally speaking, based on the statistical theory of probability, moderate inherent risk exists when there is an average probability or chance of an adverse impact on an AI's capital or earnings due to exposure and uncertainty from potential future events within the functional activity. An assessment of high inherent risk would reflect a higher than average probability of potential loss and an assessment of low inherent risk would reflect a lower than average probability. In arriving at the level of inherent risk, the degree of potential loss in relation to earnings and capital must also be considered and factored into the decision. High inherent risk could reasonably be expected to result in a significant and harmful loss to the AI. Moderate inherent risk could reasonably be expected to result in a loss, which could be absorbed by the AI in the normal course of business and low inherent risk could reasonably be expected to result in little or no loss to the AI. In assessing inherent risk, the direction of risk in the next 12 months, including the risk in any new products, must also be considered.
- 1.5.9 The second step is to evaluate by functional activity the risk management systems in place to manage the inherent risks. The risk management systems will be assessed as "strong", "acceptable" or "weak" in the areas of management oversight, policies and procedures, risk measurement and internal controls, as mentioned earlier.
- 1.5.10 The third step in phase three is to classify the composite risk profile for each of the significant business activities as "low", "moderate" or "high". This is a summary judgement arrived at by balancing the level of inherent risks of the business activity, the adequacy of the risk



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management systems for the activity and the direction of risk.

- 1.5.11 The direction of risk is required so that the assessment of risk reflects a forward as well as current view of the composite risk profile of an AI for a particular activity. For this purpose, the direction of risk is classified as “increasing”, “stable” or “decreasing”.
- 1.5.12 This means, for example, that if credit risk is the most significant risk for a particular activity conducted by an AI and it is increasing, that may prompt the HKMA to increase the composite risk profile for the activity in question (i.e. from “moderate” to “high”). If, however, the direction of credit risk is either stable or declining, it may not alter the composite risk profile for the activity concerned.
- 1.5.13 Since, however, the risk assessment process includes many judgemental considerations, it is also possible for the composite risk profile for an activity to be lowered under the same scenario of a stable or declining credit risk environment after taking into account other relevant factors. A risk profile matrix, which serves as a guide for ascertaining the composite risk profile for each significant activity and the appropriate supervisory response is set out below:



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**Risk profile matrix<sup>2</sup>**

		RISK MANAGEMENT SYSTEMS		
		STRONG	ACCEPTABLE	WEAK
INHERENT RISK	HIGH	Moderate to high aggregate risk Limited review	High aggregate risk Limited review	High aggregate risk Full-scope review required
	MODERATE	Low to moderate aggregate risk Limited or no review required	Moderate aggregate risk Limited review	Moderate aggregate risk Full-scope review required
	LOW	Low aggregate risk No review required	Low aggregate risk No review required	Low aggregate risk Limited review

1.5.14 The final step in phase three is to develop a risk matrix summary, which shows the composite risk profile and direction of risk by each type of inherent risk across all business activities. The composite risk profile by inherent risk is arrived at by balancing the level of inherent risk with the quality of risk management systems and the direction of risk. The risk matrix summary also reflects an overall risk profile and direction of risk for the AI.

1.5.15 Phase four of the risk assessment process requires the completion of a risk assessment narrative document, which is an integral part of the entire risk-based supervisory methodology. The narrative shows the overall level of risk by inherent risk category and direction. It also analyses the business activities within each of the risk categories and evaluates qualitatively management's effectiveness in managing and controlling the risks. The document also identifies key issues that

<sup>2</sup> To be applied to each significant business activity of the AI



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may affect the risk profile and contains details of the type and level of activity that was assessed. The risk assessment narrative is used to assist in determining the risk-focused examination scope.

- 1.5.16 The goal of the risk assessment narrative is to develop an overall risk profile of an AI and provide the background to how the overall risk profile for the AI has been derived. The narrative should include a discussion of the AI's key risks, describe and assess how the AI manages the risks, detail the level and trend of the risks, document the areas of supervisory concern and provide an overall assessment of the organisation.
- 1.5.17 The risk assessment narrative will also include a discussion of the AI's risk management rating, which is assigned at the conclusion of the risk-focused on-site examination. As previously indicated, the risk management rating is factored into the CAMEL rating of the AI. The narrative document will also include comments on the consolidated risk management system and the internal and external audit function.



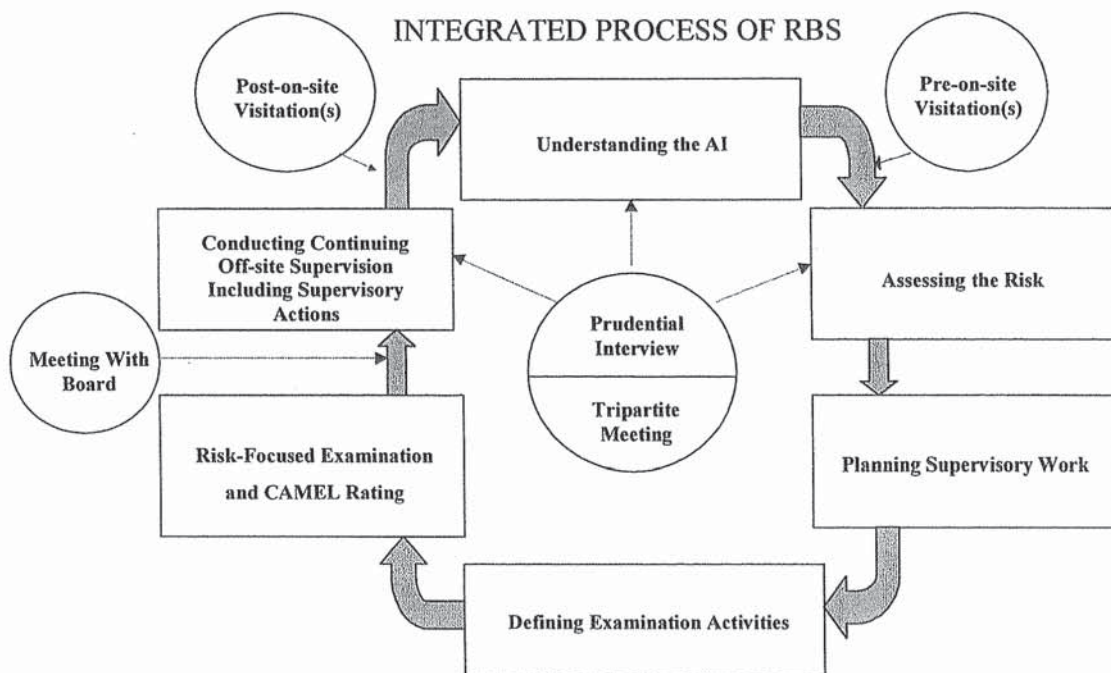
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### 1.6 Supervisory process



1.6.1 The diagram above shows how the risk-based supervisory methodology has been integrated into the HKMA's overall supervisory process in a way that provides an enhanced level of continuous supervision. The risk-based approach, which by design is circular and conducted on as current a basis as possible in a continuing cycle, is complemented and strengthened by on-site visitations, prudential interviews, annual tripartite meetings and annual supervisory meetings with the Board of Directors of locally incorporated banks.

1.6.2 On-site visitations to AIs may be conducted at any phase of the cycle but are more likely to take place during the updating of the risk assessment process prior to the start of, or subsequent to, the on-site examination. The



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purpose of the "pre-on-site" visitation is usually to obtain a current picture of recent developments, which may have an effect on the risk profile of the AI, such as the introduction of new products or any significant changes in the risk management systems. Also during the pre-on-site visitation, case officers are required to perform an assessment of the internal audit function of an AI. The assessment includes a review of the internal audit's independence and performance. The results of the assessment will be used to decide the scope for the risk-focused on-site examination. If the internal audit function is acceptable and meets the HKMA's standards, the HKMA will be able to place more reliance on its work and the scope for the on-site examination can be suitably reduced. The "post-on-site" visitation is usually conducted to follow up on the status of any significant examination findings or supervisory actions instituted.

- 1.6.3 As part of the continuous supervisory process, an annual prudential meeting is held with the senior management of an AI. The HKMA attaches great importance to this regular dialogue as it enables the supervisory officials to understand better how senior management views and controls the AI's risks and how it views the current business situation and future prospects. The meeting also provides the supervisors with an opportunity to clarify specific issues and discuss prudential concerns which have arisen during any phase of the cycle.
- 1.6.4 For AIs belonging to a banking group, prudential meetings may be held both at group level and with individual AIs of the group. In addition, the HKMA may hold discussions with overseas head offices of foreign banks, either through HKMA staff calling on them or during their visits to Hong Kong.
- 1.6.5 Annual tripartite meetings are held with AIs and their external auditors, normally following the completion of the annual audit. Matters discussed typically include any issues arising out of the audit such as weaknesses identified in internal controls, the adequacy of provisions and compliance with prudential standards and the various requirements of the Banking Ordinance. The



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HKMA will also wish to see the auditors' management letter to the AI and discuss any matters of prudential concern contained in the letter.

- 1.6.6 As a further enhancement to the continuous supervisory approach, the HKMA will hold an annual meeting with the Board of Directors of each locally-incorporated bank. This meeting will generally be conducted after the completion of the risk-focused on-site examination and updating of the composite CAMEL rating of the AI. The purpose of this meeting is generally to discuss the examination findings, particularly any significant deficiencies in the risk management systems or any other matters of prudential concern. The meeting can also be a forum for the Board members and the supervisory officials to discuss any matters of mutual interest.

### 1.7 Primary prudential obligations of an AI

- 1.7.1 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. AIs should have adequate policies, procedures, limits and controls to manage the eight types of inherent risk identified by the HKMA and any other risks which have been identified by the AI itself. Specialised board committees such as the audit committee, the risk management committee or the asset and liability management committee have a useful role to play in reviewing the adequacy of the risk management system and the extent of the overall effectiveness of it. AIs should ensure that the four elements of a sound risk management system are met (see para. 1.5.3).
- 1.7.2 The HKMA has issued various guidelines and guidance notes to the industry, which represent either minimum standards or in some cases best practices to be adopted by AIs. These guidelines and guidance notes can be found in the HKMA's Supervisory Policy Manual. AIs are expected to have systems and procedures in place to





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ensure compliance with these guidelines and guidance notes as appropriate.

## 2. The eight types of inherent risk

### 2.1 Credit risk

2.1.1 This is the risk that a borrower or counterparty may fail to fulfill an obligation. The assessment of credit risk involves evaluating both the probability of default by the counterparty, obligor or issuer and the exposure or financial impact on the AI in the event of default.

### 2.2 Market risk

2.2.1 This is the risk to an AI's financial condition resulting from adverse movements in market rates or prices such as foreign exchange rates, commodity or equity prices. The primary determinant of the inherent market risk of a business line is the volatility of the relevant markets. In assessing inherent market risk one must consider, however, the interaction between market volatility and business strategy. A trading strategy that focuses exclusively on intermediation between end-users will tend to result in less market risk than a purely proprietary strategy.

### 2.3 Interest rate risk

2.3.1 This is the risk to an AI's financial condition resulting from adverse movements in interest rates. In determining the levels of interest rate risk, assessments are made of the levels of repricing risk, basis risk, options risk and yield curve risk. In addition, evaluations are made of the funding strategy with respect to interest rate movements and the impact of the overall business strategy on interest rate risk.

### 2.4 Liquidity risk

2.4.1 This is the risk that an AI may be unable to meet its obligations as they fall due. This may be caused by "funding liquidity risk", i.e. the AI's inability to liquidate assets or to obtain funding to meet its obligations. The



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problem could also be caused by "market liquidity risk", where the AI cannot easily unwind or offset specific exposures without lowering market prices significantly because of inadequate market depth or market disruptions.

### 2.5 Operational risk

2.5.1 This is the risk of direct or indirect loss resulting from inadequate or failed internal processes, staff and systems or from external events.

2.5.2 The evaluation of operational risk involves an assessment of both product and AI-specific factors. The relevant product factors include the maturity of the product in the market, the need for significant fund movements, the impact of a breakdown in segregation of duties and the level of complexity and innovation in the market place. AI-specific factors, which can significantly increase or decrease the basic level of operational risk, include the quality of the audit function and programme, the volume of transactions in relation to systems development and capacity, the complexity of the processing environment and the level of manual intervention required to process transactions.

### 2.6 Reputation risk

2.6.1 This is the potential that negative publicity regarding an AI's business practices, whether true or not, will cause a decline in the customer base or lead to costly litigation or revenue reductions. Market rumours or public perceptions are significant factors in determining the level of risk in this category.

### 2.7 Legal risk

2.7.1 This is the risk arising from the potential that unenforceable contracts, lawsuits or adverse judgments may disrupt or otherwise negatively affect the operations or financial condition of an AI.

### 2.8 Strategic risk



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2.8.1 This is the risk of current and prospective impacts on earnings, capital, reputation or standing arising from poor business decisions, improper implementation of decisions or lack of response to industry, economic or technological changes. This risk is a function of the compatibility of an organisation's strategic goals, the business strategies developed to achieve these goals, the resources deployed to meet these goals and the quality of implementation.

### 3. Four elements of a sound risk management system

#### 3.1 Summary

3.1.1 While risk management systems vary among AIs, there are four basic elements contributing to a sound risk management environment.

- active Board and senior management oversight;
- organisational policies, procedures and limits that have been developed and implemented to manage business activities effectively;
- adequate risk measurement, monitoring and management information systems that are in place to support all business activities; and
- established internal controls and the performance of comprehensive audits to detect any deficiencies in the internal control environment in a timely fashion.

3.1.2 These are discussed in turn below.

#### 3.2 Board and senior management oversight

3.2.1 The quality of Board and senior management oversight is evaluated in relation to the following elements:

- whether the Board and senior management have identified and have a clear understanding of the types of risk inherent in business lines and whether they have taken appropriate steps to ensure continued awareness of any changes in the levels of risk;



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- whether the Board and senior management have been actively involved in the development and approval of policies to limit the risks, consistent with the AI's risk appetite;
- whether the Board and senior management are knowledgeable about the methods available to measure risks for various activities;
- whether the Board and senior management carefully evaluate all the risks associated with new activities and ensure that the proper infrastructure and internal controls are in place; and
- whether the Board and senior management have provided adequate staffing for the activity and designated staff with appropriate credentials to supervise the activity.

### 3.3 Policies, procedures and limit structure

3.3.1 The following key factors are to be considered in evaluating the adequacy of policies, procedures and limits:

- whether policies, procedures and limits are properly documented, drawn up after careful consideration of the risks associated with the activity and reviewed and approved by management at the appropriate level;
- whether policies assign full accountability and clear lines of authority for each activity and product area; and
- whether compliance monitoring procedures have been developed. These procedures should include internal compliance checks for adherence to all policies, procedures and limits by an independent function within an AI such as an internal control unit.

### 3.4 Risk measurement, monitoring and management reporting systems



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- 3.4.1 Effective risk monitoring requires AIs to identify and measure all quantifiable and material risk factors. Consequently, risk monitoring activities must be supported by information systems that provide the management with timely and accurate reports on the financial condition, operating performance and risk exposure of the AI.
- 3.4.2 Management information systems should provide regular and sufficiently detailed reports for line managers engaged in the day-to-day management of the AI's business activities.
- 3.4.3 All AIs are expected to have risk monitoring and management information systems that provide senior management with a clear understanding of the AI's positions and risk exposures.
- 3.4.4 The following factors should be considered in assessing the effectiveness of the risk measurement, monitoring and management reporting systems:
- the adequacy, on a historical basis, of the risk monitoring practices and reports addressing all material risks of the organisation;
  - the adequacy and appropriateness of the key assumptions, data sources and procedures used to measure and monitor risk, including the adequacy of analysis, documentation and reliability testing of the system on a continuing basis;
  - any material changes in the AI's lines of business or products that might require changes in the measuring and monitoring systems;
  - any changes in the information technology or management information system environment that have significantly changed the production process for reports or the assumptions on which reports are based;
  - how consistently management information reports and other forms of communication monitor all



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meaningful exposures, check compliance with established limits, goals or objectives and compare actual with expected performance; and

- the adequacy, accuracy and timeliness of reports to the Board and senior management and whether such reports contain sufficient information for them to identify any adverse trends and to evaluate the level of risks fully.

### 3.5 Internal controls and comprehensive audits

3.5.1 A critical element of an AI's ability to operate in a safe and sound manner and to maintain an acceptable risk management system is the adequacy of its internal control environment. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate segregation of duties, is one of management's most important responsibilities. Serious lapses or deficiencies in internal controls such as inadequate segregation of duties may warrant supervisory action.

3.5.2 When properly structured, a system of internal controls promotes effective operations, provides for reliable financial reporting, safeguards assets and helps to ensure compliance with relevant laws, regulations and internal policies. An independent internal auditor should test internal controls and the results of these audits, including management's response to the findings, should be properly documented.

3.5.3 The following factors should be considered in evaluating the adequacy of the internal control environment:

- the appropriateness of the system of internal controls in relation to the type and level of risks posed by the nature and scope of the AI's business activities and products;
- whether the AI's organisation structure establishes adequately clear lines of authority and responsibility for monitoring compliance with policies, procedures and limits;



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- whether reporting lines provide for sufficient independence of the control functions from the business areas, as well as adequate segregation of duties throughout the organisation (such as those relating to trading, custodial and back-office operations or loan origination, marketing and processing);
- whether the official organisational structure reflects actual operating practices;
- the reliability, accuracy and timeliness of all financial, operational and regulatory reports;
- the adequacy of procedures for ensuring compliance with applicable laws, regulations and internal policies and procedures;
- the effectiveness, independence and objectivity of internal audit or other control and review procedures in providing adequate coverage of the AI's operations;
- whether internal controls and information systems are adequately tested and reviewed;
- whether the coverage, procedures, findings and management responses to audits are adequately documented; and
- whether identified material weaknesses are given appropriate and timely high-level attention and management's actions to correct material deficiencies are objectively verified and reviewed.

## 4. Rating risk management

### 4.1 Factors considered

4.1.1. The following factors will be considered in assigning a rating to the overall risk management system at the conclusion of the risk-focused on-site examination:

- the extent to which an AI is able to manage all the risks inherent in its lending, trading, treasury and



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other major activities and in particular its ability to identify, measure, monitor and control these risks;

- the soundness of the qualitative and quantitative assumptions implicit in the risk management system;
- whether risk policies, guidelines and limits at the AI are appropriate and consistent with its lending, trading and other activities, management experience level and overall financial strength;
- whether the management information system and other forms of communication are consistent with the level of business activity and complexity of products offered at the AI and provide sufficient support to monitor risk exposure and compliance with established limits accurately; and
- the ability of management to recognise and accommodate new risks that may arise from the changing environment and to identify and address risks not readily quantified in a risk management system.

4.1.2 For example, in the lending area, an AI would be expected to have qualified and experienced lending officers, an effective credit approval and review function and, where appropriate, a credit work-out function. The lending area should also have a credit risk evaluation system that is capable of assessing adherence to credit risk lending limits, lending guidelines, portfolio policies and underwriting standards. In addition, the credit area should have a system that identifies existing and potential problem credits, the adequacy of provisioning and a method for assessing the likely impact of those credits on current and future profits. Procedures should also be in place for assessing the impact to the portfolio brought by specific or general changes in the business climate.

#### 4.2 Rating scale and integration into CAMEL rating





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- 4.2.1 The rating for risk management, which is assigned by the on-site manager at the conclusion of the on-site risk-focused examination, is based on a scale of one to five in ascending order of supervisory concern. This rating is assigned to reflect findings within the four elements of sound risk management as outlined in section 3. The risk management rating will be factored into the management component of the CAMEL rating for the AI. It may also influence the rating for one or more of the other CAMEL components. This concept adds a new dimension to the traditional methodology for assessing the CAMEL components and by extension could affect the composite CAMEL rating. The following indicates what this process entails.
- 4.2.2 The overall risk management rating is incorporated and heavily weighted in relation to the other factors included in the analysis for assessing and rating the management component of CAMEL. If the risk management rating is "3" the management component of the CAMEL cannot usually be better than "3".
- 4.2.3 As to how the risk management rating can affect other components of the CAMEL, it is necessary to consider the factors which in the above example led to an overall risk management rating of "3". If serious deficiencies were found in the credit risk management process, it may be necessary to rate the asset quality component as "3" notwithstanding that the quantitative indicators for portfolio quality may support a "2" rating.
- 4.2.4 Since the risk-based approach views the financial condition of an AI from a forward perspective, the CAMEL rating must also reflect this view, whereas the traditional methodology only captured the current position.

### 4.3 Definitions of risk management ratings

1	Management effectively identifies and controls all major types of risk posed by the AI's activities, including those from new products and changing market conditions. The Board and management are
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	<p>active participants in managing risk and ensure that appropriate policies and limits exist. The Board understands, reviews and approves them. Policies and limits are supported by risk monitoring procedures, reports and management information systems that provide management and the Board with the necessary information and analysis to make timely and appropriate responses to changing conditions.</p> <p>Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the AI. There are few noted exceptions to the AI's established policies and procedures and none is material. Management effectively and accurately monitors the condition of the AI consistent with standards of safety and soundness and in accordance with internal and supervisory policies and practices. Risk management is considered fully effective to identify, measure, monitor and control risks to the AI.</p>
2	<p>The AI's management of risk is largely effective but lacking to some modest degree. It reflects a responsiveness and ability to cope successfully with existing and foreseeable exposures that may arise in carrying out the AI's business plan. While the AI may have some minor risk management weaknesses, these problems have been recognised and are being addressed. Overall, Board and senior management oversight, policies and limits, risk monitoring procedures, reports and management information systems are considered satisfactory and effective in maintaining a safe and sound environment. Generally, risks are being controlled in a manner that does not require additional or more than normal supervisory attention.</p> <p>Internal controls may display modest weaknesses or deficiencies but they are correctable in the normal course of business. The on-site team may have recommendations for improvement but the weaknesses noted should not have a significant effect on the safety and soundness of the AI.</p>



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| 3 | <p>Risk management practices are lacking in some important ways and are therefore a cause for more than normal supervisory concern. One or more of the four elements of sound risk management are considered less than satisfactory and have precluded the AI from addressing fully a significant risk to its operations. Certain risk management practices are in need of improvement to ensure that management and the Board are able to identify, monitor and control adequately all significant risks to the AI. Weaknesses may include continued control exceptions or failures to adhere to written policies and procedures that could have adverse effects on the AI.</p> <p>The internal control system may be lacking in some important respects, particularly as indicated by continued control exceptions or by failure to adhere to written policies and procedures. The risks associated with the internal control system could have adverse effects on the safety and soundness of the AI if corrective actions are not taken by management.</p> |
| 4 | <p>Indicates marginal risk management practices that generally fail to identify, monitor and control significant risk exposures in numerous material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the Board. One or more of the four elements of sound risk management are considered marginal and require immediate and concerted corrective action by the Board and management. A number of significant risks to the AI have not been adequately addressed and the risk management deficiencies warrant a high degree of supervisory attention.</p> <p>The AI may have serious identified weaknesses, such as inadequate separation of duties, that require substantial improvement in its internal control or accounting procedures or in its ability to adhere to supervisory standards or requirements. Unless properly addressed, these conditions may result in unreliable financial records, reports or operating</p>  |



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	losses that could seriously affect the safety and soundness of the AI.
5	<p>Indicates a critical absence of effective risk management practices to identify, monitor or control significant risk exposures. One or more of the four elements of sound risk management are considered wholly deficient and management and the Board has not demonstrated the capability to address deficiencies.</p> <p>Internal controls may be sufficiently weak as to jeopardise seriously the continued viability of the AI. If not already evident, there is an immediate concern as to the reliability of accounting records and regulatory reports and about potential losses that could result if corrective measures are not taken immediately. Deficiencies in the risk management procedures and internal controls at the AI require immediate and close supervisory attention.</p>

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