

**People's Republic of China—Hong Kong Special Administrative Region:  
Financial System Stability Assessment, including Reports on the Observance of  
Standards and Codes on the following topics: Banking Supervision, Securities  
Regulation, Insurance Supervision, Payment Systems, Securities Settlement Systems,  
Monetary and Financial Policy Transparency, Corporate Governance, and  
Anti-Money Laundering and Combating the Finance of Terrorism**

This Financial System Stability Assessment on the **People's Republic of China—Hong Kong Special Administrative Region** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in **April 15, 2003**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **People's Republic of China—Hong Kong Special Administrative Region** or the Executive Board of the IMF.

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SPECIAL ADMINISTRATIVE REGION

**Financial System Stability Assessment**

Prepared by the Monetary and Exchange Affairs and the Asia and Pacific Departments

Approved by V. Sundararajan and David Burton

April 15, 2003

This Financial System Stability Assessment (FSSA) is based on work of IMF missions that visited Hong Kong Special Administrative Region (HKSAR) of the People's Republic of China as part of the Financial Sector Assessment Program (FSAP) during October and December 2002. The assessment team met with officials from the government, regulatory agencies, banks, insurance companies, securities firms, auditors, self regulatory accounting and actuarial organizations, and academics. Discussions were also held with supervisors in London, New York, and Washington, D.C., on cross border supervision issues. Follow up discussions on the FSAP findings took place from February 6–16, 2003, in the context of the mission for the 2003 Article IV consultation. The FSAP team was led by Patricia Brenner and included Udaibir S. Das (Deputy Chief), Martin Čihák, Eva Gutierrez, Kenneth Sullivan, and Plamen Yossifov (all MAE), Dora Iakova (APD), Effie Psalida (ICM), William Blair (LEG–expert), Rodney Lester and Miarta Capaul (both World Bank), John Thompson (ex-Office of the Superintendent of Financial Institutions, Canada), Göran Lind (Sveriges Riksbank, Sweden), Peter Phelan (ex-Financial Services Authority, United Kingdom), Nick Roberts (Reserve Bank of Australia), Yvon Lucas (Banque de France), Gregory Tanzer (Australian Securities and Investment Commission), and Eija Holttinen (Financial Supervision Authority, Finland). Representatives from the Office of the Executive Director for China joined a number of mission meetings.

Overall, the financial system in HKSAR is resilient, sound, and overseen by a comprehensive supervisory framework. The banking system is sufficiently well capitalized and profitable to be able to withstand the more likely macroeconomic shocks, although some pressures on bank profits are emerging. Weak domestic demand and shifts in global financial activity in HKSAR are driving banks, both the internationally active Large Complex Financial Institutions and some smaller banks to expand into investment banking, brokerage, insurance and asset management services. These trends highlight the need to strengthen regulatory and insolvency procedures for financial conglomerates and for enhanced supervisory coordination among domestic and cross border regulators. The small but growing insurance sector poses some supervisory challenges, particularly as regards the risks involved in life insurance and embedded guarantees in life insurance products. Recent reforms in payments and securities settlement systems have strengthened the market infrastructure. Further strengthening is needed in the areas of transparency, accounting, and regulatory and corporate governance to help maintain HKSAR's competitiveness as an international financial center.

The financial system is facing several important challenges as economic integration with the Mainland of China deepens and efforts continue at managing the fiscal deficit. Strong macroeconomic fundamentals thus remain the key to HKSAR's prospects for continuing to grow and compete as a financial services center. In this context further strengthening of regulatory governance arrangements dealing with systemic and financial stability issues is recommended, including by publishing periodic reports on the activities of the Council of Financial Regulators, and formalizing accountability arrangements of the financial regulators with the Chief Executive of HKSAR and the Financial Secretary.

The main authors of this report are Patricia Brenner, Martin Čihák, and Udaibir S. Das.

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## GLOSSARY

AI	Authorized Institution
AML/CFT	Anti-money Laundering and Combating Financing of Terrorism
ASHK	Actuarial Society of Hong Kong
BCP	Basel Core Principles for Effective Banking Supervision
BO	Banking Ordinance
CCASS	Central Clearing and Settlement System
CCP	Central Counter Party
CE	Chief Executive of the Hong Kong SAR
CHATS	Clearinghouse Automated Transfer System
CMU	Central Moneymarkets Unit
CNS	Continuous Net Settlement
CO	Companies Ordinance
CP	Core Principle
CPSIPS	CPSS Core Principles for Systemically Important Payments Systems
DBP	Defined Benefit Plans
DTC	Deposit-Taking Company
DPS	Deposit Protection Scheme
DTRDP	Drug Trafficking Ordinance
DvP	Delivery versus Payment
EFBN	Exchange Fund Bills and Notes
EFO	Exchange Fund Ordinance
FI	Financial Institution
FS	Financial Secretary
FSAP	Financial Sector Assessment Program
GAAP	Generally Accepted Accounting Principles
HKAB	Hong Kong Association of Banks
HKICL	Hong Kong Interbank Clearing Limited
HK\$	Hong Kong Dollar
HKEX	Hong Kong Exchanges and Clearing Limited
HKMA	Hong Kong Monetary Authority
HKMC	Hong Kong Mortgage Corporation Limited
HKSA	Hong Kong Society of Accountants
HKSAR	Hong Kong Special Administrative Region of the People's Republic of China
IA	Insurance Authority
IAE	Independent anti-money laundering expert
IAS	International Accounting Standards
ICP	Insurance Core Principle
JFIU	Joint Financial Intelligence Unit
IFC	International Financial Center
IOSCO	International Organization of Securities Commissions
LCFI	Large Complex Financial Institution
LEGCO	Legislative Council of HKSAR
LEERS	Linked Exchange Rate System
LOLR	Lender of Last Resort
MA	Monetary Authority

Mainland	The Mainland of China
MFP Transparency Code	IMF's Code of Good Practices on Transparency in Monetary and Financial Policies
MPF	Mandatory Provident Fund
MPFA	Mandatory Provident Fund Schemes Authority
MOU	Memorandum of Understanding
OECD	Organization for Economic Cooperation and Development
OCI	Office of the Commissioner of Insurance
OSCO	Organized and Serious Crime Ordinance
OTC	Over-the-Counter
RAMCs	Remittance Agents and Money Changers
RLB	Restricted License Bank
RTGS	Real Time Gross Settlement
SDDS	Special Data Dissemination Standard
SEHK	Stock Exchange of Hong Kong Limited
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance
SFST	Secretary for Financial Services and the Treasury
SME	Small and Medium-Size Enterprises
SRO	Self-Regulatory Organization
STR	Suspicious Transaction Report
SSAP	Statements of Standard Accounting Practice
UNATMO	United Nations (Anti-Terrorism Measures) Ordinance
WTO	World Trade Organization

## MAIN WEBSITES OF THE HKSAR AGENCIES

### Regulators

Hong Kong Monetary Authority	<a href="http://www.info.gov.hk/hkma/">www.info.gov.hk/hkma/</a>
Financial Services and the Treasury Bureau	<a href="http://www.info.gov.hk/fstb">www.info.gov.hk/fstb</a>
Mandatory Provident Fund Schemes Authority	<a href="http://www.mpfahk.org">www.mpfahk.org</a>
Office of the Commissioner of Insurance	<a href="http://www.info.gov.hk/oci/">www.info.gov.hk/oci/</a>
Securities and Futures Commission	<a href="http://www.hksfc.org.hk/">www.hksfc.org.hk/</a>
Joint Financial Intelligence Unit	<a href="http://www.info.gov.hk/police/jfiu">www.info.gov.hk/police/jfiu</a>

### Self-Regulatory Organizations

Hong Kong Exchanges and Clearing Ltd	<a href="http://www.hkex.com.hk">www.hkex.com.hk</a>
Hong Kong Association of Banks	<a href="http://www.hkab.org.hk/eng/main_frm.asp">www.hkab.org.hk/eng/main_frm.asp</a>
Hong Kong Securities Institute	<a href="http://www.hksi.org/default.htm">www.hksi.org/default.htm</a>
Hong Kong Investment Funds Association	<a href="http://www.hkifa.org.hk">www.hkifa.org.hk</a>

### Legal Information

Department of Justice	<a href="http://www.justice.gov.hk/">www.justice.gov.hk/</a>
Legislative Council	<a href="http://www.legco.gov.hk">www.legco.gov.hk</a>
Hong Kong Legal Information Institute	<a href="http://www.hklii.org/databases.html#legis">www.hklii.org/databases.html#legis</a>

## PART I: STAFF REPORT ON FINANCIAL SECTOR ISSUES

### I. OVERALL STABILITY ASSESSMENT

1. **The financial system of Hong Kong SAR (HKSAR) demonstrates strong resilience and is fundamentally sound.** HKSAR operates an open, highly regarded, and efficient financial system that includes many of the world's largest financial institutions. A substantial share of financial market activity is international, which has implications for financial stability. As a highly open economy, HKSAR has confronted a variety of external shocks, yet there has not been a significant financial sector crisis either at an individual financial entity level or on a systemic basis.
2. **The most important macroeconomic developments affecting the prospects and risks for the financial system are the deepening of the economic integration with the Mainland of China (Mainland), and the weakening of the fiscal position.** An economic slowdown during 2001–2002 has been reflected also in a decline in financial market activity. Under the Linked Exchange Rate System (LERS), essentially a currency board arrangement, the burden of adjustment has fallen on the domestic asset and factor markets. While a modest recovery, driven by external demand, is projected in the near term, the main medium-term macroeconomic risks comprise: renewed weakness in external demand; failure to reduce fiscal deficits as planned; and continued asset prices declines. The authorities recognize the associated risks and are taking measures to address them.
3. **Structural developments are beginning to affect the financial system.** Weak demand for corporate loans as well as declining interest rate margins on mortgage loans have encouraged banks to expand their activities more aggressively into non-traditional areas, including investment banking, insurance, and asset management services. Meanwhile the establishment of the Mandatory Provident Fund (MPF) and an important demographic transition are leading to a growing demand for diversified financial services and for insurance and retirement products.
4. **New challenges are emerging for the conduct of regulatory and supervisory policies; functioning of the legal, institutional, and governance framework; and for anticipating risks.** Issues relating to cross-market risks and cross-border transfer of risks are gaining in importance. The authorities are alert to the emerging challenges and have initiated a wide range of reforms aimed at maintaining the attractiveness of HKSAR as a financial center. Rapid technological advancements have spurred improvements to the financial infrastructure for better management of market liquidity and for supporting international financial market activity in HKSAR.

#### A. Soundness of Financial Institutions

5. **The banking system is well capitalized, liquid, and profitable compared with banks in other international financial centers globally.** Stress tests suggest that banks would be able to withstand a variety of macroeconomic shocks without major distress; credit risk poses the main channel through which banks could be affected. However,

weaknesses in the domestic and global economy, and their effect on domestic activity, have begun to encroach on the profitability of banks, especially on the smaller ones. In the face of sharp declines in real estate prices and in residential mortgage rates, banks are being forced to reduce their reliance on collateralized real estate lending and to diversify into other activities, including securities and insurance products.

6. **The stock market downturn and declining turnover have also reduced the profits of brokers, with a disproportional effect on small brokers, whose market share has declined sharply.** This, combined with competition from banks, is bringing about a consolidation in the brokerage industry. However, given the large number of small brokers, this is unlikely to pose a systemic problem, and exit from the market has thus far taken place in an orderly fashion.

7. **The small but growing insurance sector is facing new challenges as it undergoes structural changes.** Systemic linkages with the banking system are growing through embedded guarantees in life insurance products that might eventually become a significant part of a bancassurance group's portfolio. However, the market risk levels and profitability of the life sector are difficult to estimate because of lack of consistent data. The basis for collecting data is expected to improve once the definition of life business is approved in the context of proposed insurance legislation.

8. **The recently instituted MPF arrangement is facing some potential structural challenges.** MPF is a defined contribution system that is entirely managed through private sector service providers, including banks, insurers, and fund managers. The MPF is providing an ongoing source of domestic capital available to the local equities market. However, with HKSAR having one of the highest average life expectancies in the world, and facing a looming demographic transition (a relatively rapid deterioration in the "aged dependency ratio"), the MPF will have to respond to challenges arising from its high expenses, low current returns, and a projected income replacement rate that is within international norms, but that depends on maintaining the present contribution rates, long service in the system, and nonwithdrawal of funds upon separation.

## **B. Financial Markets and Infrastructure**

9. **Financial markets are well developed, liquid, and efficient, providing a wide range of products and services.** The cash and derivative warrant market is very active, while the debt market is small both by international standards and relative to the equities market. Interest-rate-linked instruments and foreign exchange derivatives are traded actively in HKSAR's deep and liquid wholesale money, foreign exchange, and other OTC derivatives markets.

10. **The market infrastructure comprises the necessary components to support efficient securities operations.** A substantial part of the securities market is still based on physical securities. Nevertheless, efficient solutions have been implemented to make the immobilization of the certificates and their transfer by book-entry possible, in particular, for



the equities held by the most active participants in the financial market. However, improvements are needed in some aspects of the legal, governance, oversight, and operational foundations of the securities settlement systems, CMU and the CCASS.

11. **Payment systems in HKSAR are efficient, and fully support the operations of the wholesale markets for money, foreign exchange, and securities trading.** As with securities settlement, the statutory basis for payments and clearing supervision needs strengthening, including to ensure finality of payments and settlement. The authorities have drafted legislation for this purpose and hope to obtain legislative approval by mid-2003.

### C. Quality of Financial System Supervision and Governance Arrangements

12. **The financial sector regulatory system is well developed by international standards.** It is characterized by transparent regulations and a strong reliance on the rule of law, and free and competitive markets. The regulatory authorities involved, particularly in banking and securities, are adequately financed, and have the necessary inspection and enforcement powers. The conduct of supervision is evolving from a focus on compliance with regulations, toward addressing prudential and market conduct issues, along with a more comprehensive assessment of financial intermediaries' risks and contingency planning. Moral suasion is relied upon frequently, given the historical proximity to regulated entities. Emphasis is given to the early detection of problems.

13. **The banking sector is overseen by a strong regulatory framework and supervisory practices, with supervisory focus on the large banks from the stability perspective.** Indeed, there has been no bank failure during the past ten years, and consolidation within the industry has taken place largely through merger and acquisition. The main supervisory challenges relate to enhancing measures for managing credit risk, the risks associated with banks' undertaking increasing activity in insurance and securities' markets, and the activities of the small domestic banks.

14. **The securities regulatory regime is undergoing modernization and reform.** A new legislative framework is being put in place with the coming into force of the Securities and Futures Ordinance on April 1, 2003. The reforms, particularly the introduction of a single licensing regime, and clarifying the treatment of financial institutions that are currently exempt from Securities and Futures Commission (SFC) supervision, are expected to improve the efficiency and transparency of HKSAR's securities markets. New provisions have also been put in place to enforce rules and impose penalties against insider trading and other anticompetitive behavior. The Hong Kong Exchanges and Clearing Limited (HKEX), which is a publicly listed, for-profit exchange, forms part of a regulatory system in which the responsibilities of the Financial Secretary, the SFC and the HKEX overlap in some cases. HKEX sets and enforces rules for issuers to become listed and continuing requirements on disclosure and corporate governance. In March 2003, the government indicated that it would keep the matter relating to SFC and HKEX under review, including considering the removal of the listing function from Hong Kong Exchanges and Clearing Limited and transferring it to the SFC.

15. **The insurance sector is posing new supervisory challenges.** The OCI lacks institutional independence and requires further autonomy on budgetary matters. Despite supervisory oversight, it mainly relies on actuaries for life insurance and self regulatory organizations for market conduct issues. The high degree of supervisory reliance on the appointed actuarial system for prudential controls, and the absence of proper standards for the approval of an appointed actuary, constitute a potential weakness, as borne out by recent international experience.

16. **Pension supervision and regulation is a new area, and systems and procedures need to be developed *pari passu* with the growth of the MPF schemes.** The Mandatory Provident Fund Schemes Authority (MPFA) is an independent agency, well organized to implement operational regulations and to monitor compliance. Strengthening is needed in adequacy of pension funding, disclosure, and consumer education.

17. **Markets are supported by robust infrastructure.** There is an efficient legal and judicial framework and strong property rights, based on common law and backed up by an independent judiciary and an effective enforcement system. However, there are gaps in the insolvency regime, as there is no corporate reorganization legislation. The regulatory and supervisory framework relating to Anti-money Laundering and Combating Financing of Terrorism (AML/CFT) measures is largely in place. The assessment found a weakness in the oversight of remittance agents and money changers regarding AML/CFT matters. The accounting and auditing professions and practices are adequate to support a market-based financial system, but improvements are needed in corporate financial disclosures.

18. **The authorities recognize that improvements in regulatory governance practices would help keep HKSAR in the forefront as an international financial center.** The HKMA and the OCI operate without explicit legislative backing and the monetary policy objective is not explicitly specified in legislation or regulation. Moreover, the procedures for appointment, terms of office, and grounds for dismissal of the Monetary and Insurance Authorities need to be made explicit. The criteria for exercising the power of the Chief Executive to remove from office the SFC's chairman and members of the Board of Directors also needs greater clarity. To improve the transparency of the institutional framework for formulation of financial policies, the circumstances under which the reserve power of the CE to direct financial regulators can be exercised also needs to be clarified.

19. **To address cross-market risks as bank involvement in securities business grows, the banking and securities supervisors are working toward coordinating their supervision.** They have also developed effective information-sharing arrangements with foreign regulators, including some offshore centers. The Council of Financial Regulators, which includes representatives from all principal supervisory agencies and the HKSAR government, and the Financial Stability Committee, which comprises of the Secretary for Financial Services and the Treasury, the Chairman of SFC and the Monetary Authority, serve as forums for exchange of information, and regulatory and policy coordination between the various supervisory and regulatory agencies and the HKSAR government.

However, more integrated liaison and coordination (cross-border–cross-market) with foreign regulators, including Mainland counterparts, would need to be continually enhanced. Cooperation arrangements with the OCI also need to be enhanced to address the bancassurance and investment-linked insurance products' regulatory risks.

20. **Recommendations to strengthen the soundness and stability of the financial system in HKSAR and enhance observance with the international best practices are summarized in Box 1 (also see Part II).**

### **Box 1. Key FSAP Recommended Actions**

**Regulatory governance and policy coordination:** The existing Council for Financial Regulators to be given an enhanced and formal oversight role on system wide issues, and made transparent. The objectives and governance structure of HKMA for monetary policy, and OCI for insurance policy to be specified in legislation or regulation. Institutional independence of these two agencies, including procedures for the appointment and dismissal of the MA and the IA to be clarified.

**Financial sector regulation and supervision:** *Banking supervision:* supervisory preconditions to be continuously strengthened, including the legal framework and governance arrangements. *Securities regulation:* Clarify regulatory roles and strengthen enforcement, notably in the delisting and supervision of listed companies. (Following release in March 2003 of an expert review of the three-tiered equity market regulatory system and consistent with FSAP recommendations, the government indicated that it would keep the matter relating to SFC and HKEX under review, including considering the removal of the listing function from Hong Kong Exchanges and Clearing Limited and transferring it to the SFC.) Improvement is also needed in the quality of disclosure by listed companies and quality of compliance with internationally accepted accounting standards. *Insurance supervision:* the steps needed most immediately are to ensure effective legal right to assets for HKSAR branches of life insurance, certifying Appointed Actuaries according to agreed rules, and establishing an independent legal basis for the OCI. *Cross-border supervision:* to meet the challenges of increasing regional competition and integration with the Mainland, it is important to strengthen cross-border information sharing mechanisms and regulatory arrangements, in particular with the Mainland regulatory agencies.

**Market foundations:** In the area of corporate governance, shareholder participation needs to be fostered, ensuring equitable treatment of minority shareholders, improving the frequency and quality of reporting, and enhancing board oversight. In the *legal area*, the key requirement is to address the corporate reorganization gap in the insolvency regime. In the area of *accounting and auditing*, it is important to: complete convergence of HKSAR accounting standards with the IAS as planned; consider a common financial statements disclosures compliance body; and enhance disciplinary procedures in case of professional misconduct. In the area of payments and securities settlements systems, priority to be given to securing legislative approval of the proposed new law that would provide statutory powers for the oversight of important payment systems and would extend the exemptions from insolvency law to all important clearing and settlement systems.

**Data collection and monitoring:** Improve the collection of data on foreign exchange risk in the corporate sector, profitability of life insurance companies and banks' profits from insurance business, the overall size of banks' large exposures to the corporate sector, and information on banks' indirect exposures to the Mainland. This would help enable the regulatory authorities to better assess potential vulnerabilities of the financial system.

## II. MACROECONOMIC ENVIRONMENT, MONETARY POLICY, AND SYSTEMIC LIQUIDITY

### A. Macroeconomic Environment

#### Recent developments

21. **HKSAR's economy appears to be emerging from a prolonged cyclical downturn, but the strength of the recovery depends largely on the strength of external demand.** The highly open economy experienced a sharp output decline and large capital outflows during the Asian crisis. A strong recovery in 2000 was truncated by the global slowdown in 2001 (Table 1). However, economic activity rebounded in 2002, fueled by robust growth in the exports of goods and services while private consumption and investment spending remained soft.

22. **Under the LERS, in practice a currency board arrangement, the burden of adjustment during the economic downturn has fallen on the domestic asset and factor markets.** Property prices have continued to drift downward since the collapse of the property price bubble, and at end-2002 were about 65 percent below their 1997 peak. Consumer price deflation has lasted for four years now, reflecting weak demand, asset price deflation, and weak import prices. The adjustment in the labor market has partially taken place through a reduction in employment in certain sectors, and the unemployment rate, which reached record levels in mid-2002, is still above 7 percent. Structural unemployment is also rising as deepening integration with the Mainland leads to a structural shift toward higher value-added services.

23. **The cyclical rise in the budget deficit has been combined with a structural weakening of the fiscal position in recent years.** Traditionally, HKSAR has conducted conservative fiscal policy, which has resulted in the accumulation of a sizable fiscal reserve. However, the fiscal position has gradually deteriorated since 1998, reflecting partly a cyclical revenue shortfall, and partly a widening of the structural budget deficit resulting from a narrow revenue base and rising expenditures.

#### Macroeconomic and financial system risks

24. **HKSAR's financial system has shown strong resilience both in the face of external shocks and during the cyclical downturn.** A stable exchange rate regime, low corporate leverage, and prudent risk management have underpinned the stability of the financial system. The main medium-term macroeconomic risks are renewed weakness in external demand; further deterioration in labor market conditions; failure to reduce fiscal deficits as planned; and continued asset prices declines. HKSAR's open economy is highly exposed to a global slowdown and is particularly sensitive to the U.S. business cycle.

Table 1. Hong Kong SAR: Key Macroeconomic Indicators, 1997–2002  
(in percent, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002
<i>Real sector</i>						
Real GDP (percent change, 2000 prices) 1/	5.1	-5.0	3.4	10.2	0.6	2.3
Nominal GDP (in US\$ billion) 1/	173.7	165.2	160.6	165.4	164.0	163.0
Consumer price index (percent change, average)	5.8	2.9	-4.0	-3.7	-1.6	-3.0
Consumer price index (percent change, e.o.p.)	5.2	-1.7	-4.0	-2.1	-3.5	-1.6
Residential property prices (percent change, average)	39.5	-28.2	-14.6	-10.4	-12.2	11.1
Gross national savings (percent of GDP) 1/	31.5	31.8	32.8	33.6	33.4	34.9
<i>Monetary and financial sector</i> (percent change, e.o.p., unless otherwise indicated)						
Value added in financial sector (percent of GDP) 2/	17.5	17.5	19.7	20.2	...	...
Money (M1)	-4.3	-5.0	13.9	8.3	5.8	14.6
Broad money (M3)	8.2	10.3	8.4	7.5	-2.7	-0.9
Hong Kong dollar M3	9.9	9.3	5.1	3.5	0.7	-0.6
Domestic credit (loans for use in HKSAR) 3/	24.4	-3.8	-7.2	2.3	-3.8	-2.6
Reference bank lending rate (best rate, percent)	9.5	9.0	8.5	9.5	5.1	5.0
Three-month HIBOR (percent)	9.1	5.0	5.7	5.7	1.9	1.4
HIBOR (3M) – LIBOR (3M) (basis points) 4/	159.3	267.3	45.5	-41.8	-17.5	-0.6
Heng Seng stock index	-20.3	-6.3	68.8	-11.0	-24.5	-18.2
<i>Public finances</i> (in percent of GDP)						
Consolidated budget balance 1/	6.5	-1.8	0.8	-0.6	-5.0	-5.5
Reserves at the end of fiscal year (end-March) 1/	34.0	33.9	35.6	33.4	29.2	23.8
<i>External sector</i> (US\$ bill., unless otherwise indicated)						
Nominal exchange rate (HK\$ per U.S. dollars)				Fixed at HK\$7.80 per US\$1		
Real effective exchange rate (period ave., 1990=100)	149.4	161.6	151.1	146.6	149.4	142.6
Current account balance 1/	-5.3	4.4	12.0	9.1	12.3	17.5
In percent of GDP 1/	-3.1	2.7	7.5	5.5	7.5	10.7
Merchandise trade balance	-17.3	-7.8	-3.2	-8.2	-8.3	-5.1
In percent of GDP 1/	-10.0	-4.7	-2.0	-5.0	-5.1	-3.1
Foreign direct investment (net) 1/	...	-2.2	5.2	2.6	12.4	-4.0
Portfolio investment (net) 1/	...	22.1	33.1	24.5	-41.3	-37.3
Gross official reserves (end period)	92.8	89.6	96.3	107.6	111.2	111.9
In months of retained imports	14.6	17.1	19.8	18.0	20.4	21.9
In percent of monetary base	355.1	360.6	318.3	388.7	377.0	355.2
In percent of M3	25.8	22.3	22.1	23.0	24.4	24.8
Short-term debt	174.3	101.4	83.2	79.8	69.0	66.9
In percent of gross reserves	187.8	113.2	86.5	74.1	62.1	59.8

Sources: HKSAR authorities; and staff estimates and projections.

1/ The 2002 figure is a staff estimate.

2/ Financial services, financial intermediation services indirectly measured, and insurance.

3/ Excludes trade finance.

4/ Period average.

25. **Shocks to international financial markets could have a disproportionately large effect on domestic activity.** Financial intermediation services contribute some 20 percent to value added (Table 1). Thus, a shock to financing flows to the region would affect GDP growth both directly and indirectly (through the effect of reduced financial intermediation activity on domestic demand).

26. **Continuing government withdrawals of fiscal reserves could affect market sentiment.** Between end-2000 and end-2002, fiscal reserves, deposited in the Exchange Fund, declined by US\$14.5 billion to help finance the fiscal deficit. This was accomplished mainly by liquidating Hong Kong dollar assets through the sale of domestic stocks purchased during a 1998 stock market intervention. Thus, gross official foreign exchange reserves did not decline during this period. However, future withdrawals of fiscal reserves may have to be effected by the liquidation of foreign currency fiscal assets, which could result in a net decline of official reserves and thus affect market sentiment regarding the future resilience of the LERS.<sup>1</sup>

27. **The longer-term outlook depends on how HKSAR meets the challenges of integration with the Mainland and increasing regional competition.** In the near term, the volume of Mainland-related trade is expected to increase following China's accession to the WTO, which should support the vibrancy of the financial sector. However, increasing competition from other regional financial centers and rising direct trade linkages between the Mainland and other economies could reduce the need for HKSAR-based intermediation services. Some intermediaries may relocate their operations from HKSAR to the Mainland, attracted by proximity to clients, cheaper labor costs, and continuously improving financial infrastructure (especially in Shanghai).

#### **B. Monetary Policy and Systemic Liquidity Arrangements**

28. **The overriding monetary policy objective in HKSAR is to maintain a stable exchange rate between the Hong Kong dollar and the U.S. dollar.**<sup>2</sup> Historically, the currency board has underpinned confidence in HKSAR as a stable financial center, and provided a clear anchor to economic decision-making and market expectations. Strong fundamentals and prudent policies have enabled the economy to adjust well to cyclical shocks and structural changes under the link.

29. **A high level of international reserves contributes to the credibility of the LERS.** Gross official reserves amounted to 355 percent of the monetary base and 25 percent of

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<sup>1</sup> In October 2002, Standard and Poor's rating agency changed HKSAR's long-term local currency outlook from "stable" to "negative," citing the large budget deficits.

<sup>2</sup> While this objective is well understood by the public (the exchange rate has been pegged at HK\$7.8=US\$1 since 1983), it is not specified in legislation.

broad money (43.5 percent of HK\$ M3), as of end-2002. Excess reserves, well beyond those needed to back the monetary base, provide a degree of flexibility to inject liquidity in exceptional circumstances without compromising the discipline of the currency board. The strength of the LERS is also reflected in the narrow spreads between HKSAR and the U.S. short-term interbank rates.

30. **HKMA's reserve management practices are sophisticated and transparent.** The objectives of reserve management are publicly disclosed and explained in the HKMA's annual report. HKSAR publicly discloses its international reserve position and foreign exchange liquidity on a monthly basis, in accordance with the IMF's Special Data Dissemination Standards.

31. **Monetary and fiscal operations are well coordinated.** Fiscal deficits have resulted in an increase in HKMA's borrowings from the money market, but this has not put pressure on interest rates, given ample liquidity in the system. Overnight and intraday liquidity facilities of the HKMA are well designed to preserve the discipline of the LERS. Banks can obtain liquidity from the HKMA through the discount window by arranging repurchase agreements of eligible securities, mostly Exchange Fund bills and notes (EFBNs) which are backed by foreign currency. The amount of available collateral is 25 times the maximum daily lending, indicating that the HKMA has a wide margin to respond to banks' liquidity needs. Intraday liquidity is provided by the HKMA free of charge through the repurchase of EFBNs to direct clearing members of the RTGS system (all licensed banks and approved RLBs).

32. **The HKMA can provide emergency liquidity support to licensed banks through its lender-of-last-resort (LOLR) facility.** The preconditions for obtaining LOLR support include the possibility of systemic risk that could arise from the failure of a troubled institution if it is deprived of liquidity assistance; sufficient margin of solvency; adequate collateral; and a demonstration that the institution has already sought other reasonably available sources of funding. HKMA can provide liquidity through the LOLR facility through purchase of the institution's interbank deposits, repurchases of eligible securities, and a credit facility against the security of the institution's residential mortgage portfolio. The resources for providing such support would be drawn from the Exchange Fund in accordance with the Exchange Fund Ordinance (EFO). This facility has not been activated since it was formalized in 1999.

### III. FINANCIAL SYSTEM STRUCTURE AND TRENDS

#### A. HKSAR as an International Financial Center

33. **HKSAR is an important IFC where most global FIs in banking, insurance, and securities business maintain a presence, either through subsidiaries or branches.** Many international fund managers maintain their Asian-Pacific headquarters in HKSAR, as a regional hub for managing foreign investors' funds, as well as a gateway for promoting global financial products to domestic investors. The position of HKSAR as an IFC is

enhanced by the well-functioning and dependable regulatory, legal, and physical infrastructure; strategic geographic location; the continuous upgrading of the financial infrastructure; and the non-discriminatory low-tax regime (Box 2). For many international banks, HKSAR is an important collection center for obtaining local funds to invest abroad and is also a major regional funding center, especially for the Mainland.

### **Box 2. Taxation and the Financial System in HKSAR**

One of the factors that make HKSAR attractive to foreign capital is its simple non-discriminatory tax regime, characterized by low tax rates, a flat tax profile, and a limited number of taxes. There are three main direct taxes: profits tax (16 percent rate), salaries tax (15 percent rate maximum), and property tax (15 percent of the rental amount payable to the owner for use in the year of assessment). There are no taxes on interest, no capital gains taxes, no taxes on dividend income, no sales tax or VAT, and virtually no withholding taxes. Deductible allowances are equally generous. Other important taxes in HKSAR include the stamp duty (payable on securities transactions, by both the seller and the buyer, at 0.1 percent each), estate duty (applying to companies owning assets in HKSAR), and customs duties. Unlike some other jurisdictions in the region, HKSAR does not have special tax incentives for fund managers and corporate bond issuers.

HKSAR has one of the few tax regimes that follow closely the territorial principle. This means that only profits or income arising in or deriving from HKSAR are subject to tax in HKSAR. A substantial number of funds flowing through HKSAR may be treated as offshore in source, in which case their tax-free status needs to be established with the Hong Kong Inland Revenue Department. Due to the territorial principle, many entities have set up booking center operations in HKSAR, under which only invoicing, banking, and accounting activities are carried out within HKSAR. So long as contracts of sale are negotiated and executed outside the jurisdiction and so long as the goods never enter HKSAR, the payment received, accounted for, and invoiced from the territory is not deemed HKSAR source income and so is not subject to profits tax.

34. **HKSAR compares favorably with other IFCs in the Asia-Pacific region (Table 2).** It ranks third by the size of its banking system (measured by total assets) and financial markets (measured by stock market capitalization as well as by foreign exchange market turnover), and is the most open economy in the region, benefiting from a liberal regime toward foreign bank and equity ownership, and an absence of controls on foreign exchange transactions of both residents and non-residents. Market confidence in the financial system is high, measured by the highest ratio (in the region) of banks' foreign liabilities to total liabilities.

### **B. Cross-Sector Issues**

35. **The financial system is dominated by a few large complex financial institutions (LCFIs) domiciled abroad, although many of the small financial institutions have complex structures as well.** The LCFIs are major suppliers of funds in the interbank market, act as market makers in several of the exchange-traded contracts, hold a significant share in the OTC market, and are dominant in the underwriting and placing of private securities in the debt market. However, even small banks are becoming part of complex conglomerates that include securities brokerages or, increasingly, insurance companies.



Table 2. Hong Kong SAR: Comparative Standing among International Financial Centers, 2001 1/

	Asia-Pacific Region						Luxem- bourg	Zurich (Switzer- land)	London (UK)	New York (USA)
	HKSAR	Sydney (Australia)	Shanghai (Mainland)	Tokyo (Japan)	Seoul (Korea)	Singa- pore				
<i>Economies of scale and scope (bln. US\$)</i>										
Deposit money banks total assets	789	379	1,947	6,473	461	191	573	876	4,183	9,435
Stock market capitalization 2/	498	376	520	1,578	197	109	400	496	1,800	10,410
Domestic bonds outstanding 3/	44	170	368	5,817	293	52	...	159	921	15,290
Spot foreign exchange market turnover (daily average)	19	13	...	37	6	34	4	23	151	104
Derivatives FX market turnover (daily average)	49	39	...	110	4	66	9	47	353	150
OTC single currency interest rate derivatives turnover (daily average)	3	10	...	16	8	3	4	10	238	116
Consolidated international claims of reporting banks on country	100	44	27	97	32	55	99	69	499	787
<i>International economic links</i>										
Exports of goods and services as % of GDP	141	22	...	10	43	...	...	44	27	10
Number of domestic banks ranked in the world top 1000	13	9	15	121	14	3	7	36	36	228
Deposit money banks foreign assets as % of total assets 4/	51	8	6	12	6	32	...	51	53	5
<i>Credibility and creditworthiness</i>										
International reserves (bln. US\$)	111	18	219	401	104	76	...	36	38	70
Deposit money banks foreign liabilities as % of total liabilities 5/	33	26	2	9	5	33	...	47	53	7
<i>Memorandum item</i>										
Deposit to loan ratio (%)	154	75	109	108	86	92	...	77	81	...

Source: IMF (International Financial Statistics), BIS (Triennial Central Bank Survey, International Banking Statistics), Bloomberg, The Banker Magazine, and IMF staff estimates.

1/ Data are for the economies in which the respective IFCs are located.

2/ Main Board for HKSAR.

3/ For HKSAR, Hong Kong dollar debt instruments other than Exchange Fund bills and notes.

4/ Foreign assets refer to total external claims.

5/ Foreign liabilities refer to total external liabilities.

36. **Increasing cross-border and cross-market activities are reshaping the financial landscape and presenting new challenges to regulators.** In particular, this includes:

- **Economic integration with the Mainland.** Increased integration with the Mainland will imply more cross-border trade and investment. HKSAR based banks and securities firms will, to an increasing extent, open subsidiaries and branches in the Mainland and vice versa. A major regulatory challenge will be to harmonize the laws, rules, and practices pertaining to banks and securities firms in the HKSAR and in the Mainland, at the level of the international minimum standard. A non-harmonized environment could lead to regulatory arbitrage and increasing risks for instability in the banking system. Supervisory monitoring of HKSAR banks' risk taking will be made more difficult by the sometimes highly complex ownership and organizational structures of borrowing companies, with links both to the HKSAR and to the Mainland. Financial institutions and supervisors must therefore have the powers to require transparency and disclosures to be able to fully evaluate the true state of the legal and financial situation of borrowers and other counterparties.
- **Changes in the financial sector structure and increasing cross-market links.** The weak macroeconomic performance has increased pressures on banks' core business, leading them to expand into other areas, including selling third-party collective investment products, such as unit trusts and MPFs, on a commission basis, together with various insurance products. In a number of cases, banks have set up subsidiaries or associate companies to provide such products.

### **C. Financial Intermediaries and Markets**

#### **Deposit-taking institutions**

37. **Banks are the dominant institutions in the financial system, accounting for two-thirds of its total assets (Table 3).** The ratio of domestic credit to GDP (about 130 percent) is similar to the values of high-income economies. The volume of loans syndicated in HKSAR is the second largest in Asia. Banks are the major source of finance for domestic companies, although the share of non-bank borrowing has increased, similar to the experience of other developed economies such as Japan and the U.K.

38. **Despite the large overall number of institutions, the banking system is highly concentrated and has a quasi-oligopolistic structure.** The banking system consists of 229 authorized institutions (AIs), which are licensed banks, restricted license banks (RLBs), and deposit-taking companies (DTCs). However, a small number of internationally diversified banks dominate the system. The largest banking group accounts for 32 percent of total customer deposits, and the three largest groups account for 57 percent.

39. **Interest margins in HKSAR have been high by developed countries standards, which has contributed to a traditionally high profitability of banks in the local market.**

A cartel on deposit rates was finally phased out in 2000–01, and residential mortgage rates have declined substantially since then, but the aggregate net interest margin has not declined (Table 4).

40. **Offshore activity, in which non-local parties book their transactions in HKSAR-licensed bank entities, appears to have declined substantially over the last few years, although the data are incomplete.** Banking transactions, such as in euro-yen loans, have been registered in HKSAR for tax reasons while the parties to the transaction are domiciled abroad. The Japanese banks, which earlier dominated this market, have reduced their activities in HKSAR.

41. **Total assets of AIs have declined by 27 percent since 1997 (Table 3).** The decline can be attributed to a fall in Japanese banks' assets in HKSAR, which outweighed an increase in total assets of other AIs in the same period. Also, the number of AIs has declined by 37 percent since 1997, resulting mainly from a reduction of activities by the Japanese banks (about half) and mergers and acquisitions among HKSAR's banks (almost half).

42. **Banks' domestic lending has also been shrinking in recent years, with a 15 percent decline between 1997 and 2002, despite a modest increase in deposits.** At the same time, bank's holdings of securities and other investments have almost doubled.

#### **Insurance companies**

43. **The insurance industry is small, although it has shown considerable growth in the recent past from the small base.** About 20 percent of the insurance market is controlled by banking groups. Total gross premium increased by 18.5 percent in 2001 and reached the equivalent of 5.9 percent of GDP, with an average per capita expenditure on insurance of equivalent to around US\$1,450. Life insurance, in particular has expanded rapidly, with total life insurance premiums in 2001 amounting to HK\$56.9 billion, up from HK\$46.5 billion in 2000.

44. **While the life insurance market is mostly in foreign hands, the non-life market has a large local insurer presence.** Life insurance is dominated by branches of foreign companies, with significant operations around the world, and seven Bermudan companies operating mainly in HKSAR. The dominant products are non-linked whole life policies, while new business is largely in unit-linked policies with limited guarantees denominated in Hong Kong dollars. The currency risk of unit linked polices is usually assumed by the policyholder. In the non-life market, the dominant lines include accident and health, motor vehicle, and property damage and general liability insurance. HKSAR is also an important regional center for non-life reinsurance.

#### **Brokers and fund managers**

45. **HKSAR is a regional center for portfolio management firms, offering a wide range of collective investment schemes.** The number of licensed brokers in HKSAR

(490, taking into account only stock exchange participants who are licensed securities dealers) is large compared with Singapore (33) and the U.S. (180). The stock market downturn and declining turnover have reduced the profitability of brokers, with a disproportionate effect on the smaller ones.

46. **HKSAR is a large fund management center consisting mainly of institutional holdings of equities and other instruments.** About 70 percent of assets under management in authorized funds belong to foreign investors. There are 172 companies that provide fund management or advisory services, or derive gross operating income from such activities (compared with about 70 companies in Japan), managing some 2,231 authorized funds. Institutional and pension funds account for 61 percent and 25 percent respectively of total assets under management by international financial managers.

#### **Other financial intermediaries**

47. **Other non-bank financial intermediaries operating in HKSAR include a small number of money brokers who arrange trades in the interbank market and are licensed by the HKMA, moneylenders, financial companies, intermediaries, hire purchase companies, and leasing companies.** The information on the activities of these institutions is limited, and is not subject to any prudential or market conduct supervisory oversight (with the exception of money brokers).

48. **Hedge funds are believed to have had significant operations in HKSAR in the late 1990's, although there is little data because, as elsewhere, their operations were largely unsupervised.** Their activities were confined to specific categories of non-public investors, such as institutional investors or professionals. The offering of hedge funds to the public was liberalized in May 2002, when the SFC issued the Guidelines on Hedge Funds. Since then, four public hedge funds have been authorized, whose combined net asset value amounted to HK\$1.25 billion at end-2002, a tiny fraction of the net asset value of all SFC-authorized funds (HK\$2,667 billion).

49. **The Hong Kong Mortgage Corporation (HKMC), which is a wholly owned subsidiary of the Exchange Fund, carries out an important intermediary role in the mortgage market.** It also provides liquidity to the banking system and facilitates the mortgage-backed and debt securities market. The mission supports the authorities' intention to consider privatization of HKMC should its operation expand significantly and under appropriate market conditions.

#### **Financial markets**

##### ***Equity market***

50. **The stock market is about the same size as in Switzerland, in terms of capitalization, and about one-quarter of the size of the Japan or the U.K. markets.** Market capitalization is high in HKSAR relative to other IFCs in the region, but liquidity (measured by the turnover-to-capitalization ratio) is relatively low (Table 2). Equity

issuance by Mainland companies in HKSAR equity markets is growing, with HKSAR's stock market accounting for over 80 percent of capital that Mainland companies raise outside of the Mainland.

### *Debt market*

51. **The debt market is small relative to the equities market as well as by international comparison.** Banks and the equities market have been highly efficient financial intermediaries. As banks have ample liquidity, there is additional pressure to reduce the cost of bank loans, and to design loan instruments that better suit borrowers. It is unlikely that demand conditions in the Hong Kong dollar debt market will change much in the short term, but this could change in the medium to long term, with the projected growth of the domestic pension fund schemes. The need to match the currency, maturity, and cash flow profiles of these funds' assets and liabilities is likely to create strong demand for Hong Kong dollar instruments of long maturities.

### *Money market*

52. **HKSAR is an important liquidity center from which international banks obtain funds to invest abroad.** Most of the funds are placed by licensed banks in the international interbank market in foreign currency, mainly in U.S. dollars. In the domestic currency interbank market, RLBs and DTCs account for 42 percent of the total Hong Kong dollar borrowing, although they only hold 5 percent of the total assets of the system.

53. **Interbank assets declined by 23 percent between end-2000 and end-2002, mainly reflecting lower foreign currency placements in the international market and a fall in Hong Kong dollar lending in the domestic interbank market.** There has also been a reallocation of assets in Hong Kong dollars away from interbank placements to other assets, mainly debt securities.

54. **Trading is active in deep and liquid money and foreign exchange markets.** Money markets are effective in redistributing the liquidity of the banking sector, as indicated by the low level of discount window activity compared to the daily turnover in the cash interbank market. Daily foreign exchange turnover is equivalent to 41 percent of annual GDP, compared with 35 percent in the U.K.

55. **HKSAR's wholesale market includes all the major categories of OTC derivatives.** Although foreign exchange-based derivatives remain the dominant type of instrument, the market is growing for non-deliverable-forwards and equity-linked notes and options. Despite the trend toward increased sophistication, the bulk of derivatives trading remains of simple types that do not require exceptionally sophisticated risk analysis expertise and are, therefore, relatively easy to manage and supervise.

Table 3. Hong Kong SAR: Structure of the Financial System, 1997–2002

	Number of institutions				Total assets in US\$ billion				% of total assets		% of GDP	
	Dec-97	Dec-99	Dec-01	Jun-02	Dec-97	Dec-99	Dec-01	Jun-02	Dec-97	Dec-01	Dec-97	Dec-01
Authorized (deposit-taking) institutions	361	285	250	229	1,076.6	869.8	789.0	780.6	84.3	66.6	624.5	481.2
Licensed banks	180	156	147	133	1,011.1	828.9	753.6	746.2	79.1	63.7	586.5	459.6
Incorporated in the HKSAR	31	31	29	27	254.3	285.7	381.4	376.3	19.9	32.2	147.5	232.6
Incorporated outside the HKSAR	149	125	118	106	756.8	543.3	372.2	369.9	59.2	31.4	439.0	227.0
Restricted license banks	66	58	49	48	45.5	31.7	28.7	28.4	3.6	2.4	26.4	17.5
Deposit-taking companies	115	71	54	48	20.0	9.2	6.6	6.0	1.6	0.6	11.6	4.1
Institutional investors	20,080	21,191	12,635	2,270	171.2	348.1	345.7	277.3	13.4	29.2	100.1	213.6
Insurance companies	215	207	204	203	25.4	31.2	35.0	...	2.0	3.0	14.8	21.6
General and composite insurance	170	165	159	155	2.5	2.1	2.3	...	0.2	0.2	1.5	1.4
Pure long-term insurance	45	42	45	48	22.9	29.0	32.7	...	1.8	2.8	13.4	20.2
Collective investment schemes	19,865	20,984	12,431	2,067	145.9	316.9	310.7	277.3	11.4	26.2	85.3	191.9
Unit trusts and mutual funds	1,472	1,577	1,893	1,900	132.4	298.9	285.2	277.3	10.4	24.1	77.4	176.2
Investment-linked assurance schemes	60	63	98	109	...	...	...	...	...	...	...	...
Pooled retirement funds	18,259	19,285	9,809	...	13.5	18.1	20.9	...	1.1	1.8	7.9	12.9
Provident schemes, constituent funds, and pooled investment funds	...	...	579	...	...	...	4.6	...	...	0.0	...	2.9
Others	74	59	52	58	...	...	...	...	...	...	...	...
Registered intermediaries	1,659	1,601	1,689	1,695	29.9	36.4	49.2	21.1	2.3	4.2	17.5	30.4
Securities intermediaries	1,346	1,297	1,397	1,402	29.5	36.0	36.9	19.3	2.3	3.1	17.2	22.8
Dealers 1/	707	695	720	718	14.1	14.1	14.6	18.3	1.1	1.2	8.2	9.0
Advisers	639	602	669	676	15.4	21.9	21.3	...	1.2	1.8	9.0	13.1
Margin financiers	...	...	8	8	...	...	1.0	1.0	...	0.1	...	0.6
Commodities intermediaries	292	288	281	283	0.1	0.1	12.1	1.5	0.0	1.0	0.1	7.4
Dealers 1/	162	160	155	155	0.1	0.1	1.5	1.5	0.0	0.1	0.1	1.0
Advisers	130	128	126	128	0.0	0.0	10.5	0.0	0.0	0.9	0.0	6.5
Leveraged foreign exchange traders 2/	21	16	11	10	0.3	0.3	0.3	0.3	0.0	0.0	0.1	0.2
Other financial intermediaries 3/	1,139	1,035	865	835	0.1	1.8	8.5	0.0	0.0	0.7	0.1	5.2
Hong Kong Mortgage Corporation	1	1	1	1	0.1	1.8	3.0	...	0.0	0.3	0.1	1.8
Money lenders	1,138	1,034	864	834	...	...	5.5	...	...	0.5	...	3.4
Total financial system	22,100	23,077	14,574	4,194	1,277.7	1,254.3	1,183.9	1,079.1	100.0	100.0	747.2	731.2
Memorandum items:												
Local representative offices of foreign banks	159	127	111	102	...	...	...	...	...	...	...	...
Companies listed in the stock market 4/	658	708	867	924	410.6	606.1	498.1	486.1	...	...	240.1	307.7

Source: HKSAR authorities and IMF staff estimates.

1/ Dealers who also have adviser licenses are included here and eliminated from the adviser category.

2/ Leveraged foreign exchange traders are not required to report total assets in their monthly financial returns. Total liquid assets are shown as a proxy for total assets.

3/ Finance, hire purchase, and leasing companies; however, comprehensive data on them are not available.

4/ The number of listed companies and market capitalization of the HK cash market (Main Board) in U.S. billion dollars, respectively.

## **Payments and securities settlement system**

56. **HKSAR has modernized its payment system, thus enhancing the robustness and competitiveness of the financial infrastructure.** A Real-Time Gross Settlement System—Clearinghouse Automated Transfer System (CHATS)—was introduced in 1996, facilitating the clearing and settlement of large value interbank payments. The Hong Kong dollar RTGS is the key system supporting the operations of the wholesale markets for money, foreign exchange, and securities trading. A U.S. dollar RTGS was launched in August 2000, to provide efficient settlement of U.S. dollar transactions during Asian business hours. The HKMA also intends to develop a Euro and a Yen RTGS, so that HKSAR can offer more comprehensive foreign exchange and securities settlement services. Payments through the RTGS systems make up 85 percent of the value of gross non-cash payments exchanged between banks in HKSAR, with the remainder mainly accounted for by checks and electronic bulk clearing items.

57. **The cash to GDP ratio (9 percent) is relatively high, reflecting in part foreign holdings of Hong Kong dollars in Macao and bordering areas of the Mainland.** Credit cards account for almost 20 percent of all retail payments (including cash), a slightly higher share than checks. There are initiatives to encourage check and other payments activity between HKSAR and the Mainland. Debit cards and automated clearinghouse facilities are a growing component of the retail payments system.

58. **The technical infrastructure relating to securities settlement systems is efficient and robust.** The legal framework supports securities custody, clearing, and settlement. The CCASS, which supports clearing and settlement of securities traded on the Stock Exchange of Hong Kong (SEHK), is currently being upgraded. The CMU is actively developing links with foreign securities settlement systems (in Australia, New Zealand, South Korea, and in Europe, Clearstream and Euroclear) and settlement of securities in foreign currencies. A link between the Mainland Government Securities Book-Entry System is expected to begin operation in the middle of 2003.

## **D. Safety Nets**

59. **A draft bill on a deposit protection scheme (DPS) was issued for further industry consultation on December 2002.** Currently, the only protection for depositors is priority in the event of bank liquidation. The scheme would be funded by the industry, and provides limited "pay-box" deposit protection, with activities limited to collection of fees, managing the deposit protection fund, and making payments as required. Coverage would be set at HK\$100,000 (equivalent to US\$12,820) per depositor per bank. Moral hazard is expected to be contained by the relatively low protection limit and the linkage of banks' contributions to their supervisory (CAMEL) ratings. The authorities intend to present the final bill to the LEGCO in the first half of 2003 and envisage that the scheme could become operational in 2005. The staff encourages prompt approval and implementation of the proposed legislation.

60. **Steps are also underway for creating consumer protection schemes in the securities and insurance areas.** An investor compensation fund is being created under the new SFO. The authorities are aware of the need to ensure coordination between the Investor Compensation Fund and the proposed DPS. The authorities are also conducting a feasibility study on an Insurance Policyholders' Protection Fund.

#### IV. VULNERABILITIES AND SOUNDNESS OF THE FINANCIAL SYSTEM

61. **The regulatory system is organized along traditional sectoral lines** (also see Part II). The principal regulatory and supervisory agencies/public servants in HKSAR responsible for the implementation of monetary and financial policies are: (1) the Monetary Authority (MA), assisted by his office, known as the HKMA—monetary policy implementation, banking supervision, payment and settlement systems oversight; (2) the Securities and Futures Commission (SFC)—securities markets regulation with the exception of the payment system relating to securities settlement oversight; regulation of listed companies is split between the SFC and Hong Kong Exchanges and Clearing Limited (HKEX); (3) the Insurance Authority (IA) assisted by his office known as the Office of the Commissioner of Insurance (OCI)—insurance regulation; and (4) the Mandatory Provident Fund Schemes Authority (MPFA)—pension system oversight.

##### A. Banking Sector

62. **The banking sector has traditionally been well run and sound.** The system is characterized by: (1) high levels of profitability and liquidity by international comparison; (2) high capital adequacy ratios; (3) a low level of classified loans; (4) resilience to external shocks in the past;<sup>3</sup> (5) absence of recent episodes of bank insolvency; (6) small direct exchange rate risk of banks, reflecting only small open positions in foreign exchange; (7) low corporate leverage ratios; and (8) strong banking regulations and supervision practices.<sup>4</sup>

63. **Banks' profits seem to provide a sufficient buffer against external shocks.** Stress tests, performed on a bank-by-bank basis by the HKMA and based on detailed consultations with the team, suggest that banks would generally be able to withstand a combination of further declines in property prices, increases in classified loans and provisioning, and changes in interest rates that correspond to or even go beyond the 1997–98 scenario (Table 5). The results suggest that no bank would become insolvent as a result of the assumed shocks. Given the authorities' confidentiality constraints, the mission did not have access to the actual supervisory data. Nonetheless, the stress test results were broadly verified by the team's independent analysis, based on aggregate information and on publicly available bank-by-bank data. Neither the aggregate result, nor the range of the results derived by the staff differed significantly from those based on supervisory information.

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<sup>3</sup> See SM/01/23 for an analysis of how HKSAR's banks weathered the Asian crisis.

<sup>4</sup> See Table 4 and Part II.



Table 4. Hong Kong SAR: Financial Soundness of the Banking System, 1997–2002  
(in percent, unless otherwise indicated)

Aggregate data for all AIs	Dec-97	Dec-98	Dec-99	Dec-00	Dec-01	Dec-02
<i>Capital adequacy</i>						
Regulatory capital to risk-weighted assets 1/	17.4	18.5	18.7	17.8	16.5	15.8
Regulatory Tier I capital to risk-weighted assets 1/	13.7	15.2	15.5	14.8	13.7	13.1
<i>Asset composition and quality (as share of total loans, unless indicated otherwise)</i>						
Classified loans (gross) 2/	1.2	5.3	7.2	6.1	5.7	4.5
Classified loans (net of provisions) to total capital 3/ 4/	6.2	26.8	31.8	23.7	25.4	20.0
Total loans to total assets	49.1	45.6	41.5	37.0	35.5	34.6
Loans to property sector	21.4	27.0	31.4	36.4	40.6	43.5
Loans to FIs other than AIs	6.3	7.1	6.7	6.9	6.5	6.0
Loans to manufacturing	2.7	2.9	2.9	3.0	3.3	3.4
Foreign exchange loans 5/	57.7	48.7	42.9	32.9	24.6	22.2
Direct lending to the Mainland	4.9	4.5	3.6	3.3	3.2	2.1
<i>Earnings, expenses, and profitability</i>						
Return on average assets (after tax)	0.6	0.3	0.4	0.8	0.8	0.8
Return on average equity (before tax) 1/	15.9	9.2	12.2	15.5	15.2	14.9
Return on average equity (after tax) 1/	13.8	7.8	11.1	13.5	13.9	13.3
Cost-income ratio	45.9	48.3	44.2	45.5	48.0	47.2
Net interest margin	1.1	1.1	1.3	1.4	1.4	1.5
Noninterest expenses to total gross income	45.9	48.3	44.2	45.5	48.0	47.2
Spread between reference loan and deposit rates 4/	2.9	3.3	4.0	4.4	4.6	4.8
<i>Liquidity 5/</i>						
Liquid assets to total assets	16.1	18.5	21.4	24.2	25.3	27.7
Liquid assets to short-term liabilities	51.2	54.6	54.1	54.4	52.6	53.5
Customer deposits to loans (all currencies)	64.6	89.4	113.0	141.5	153.7	159.7
Deposits to loans (HK dollar, incl. swap deposits)	88.2	99.4	109.6	111.8	112.3	112.9
Demand deposits to total liabilities	1.5	1.6	1.9	2.3	2.5	3.0
FX liabilities (excl. swap deposits) to total liabilities	65.2	60.4	57.5	54.2	52.6	52.4
<i>Sensitivity to market risk</i>						
Net open position in foreign exchange to capital 3/	4.6	5.0	13.8	16.9	18.9	25.5
Net asset position in derivatives to capital 3/	-9.1	18.7	42.6	33.3	49.0	44.3

Source: HKMA, and IMF staff calculations.

1/ Consolidated numbers for locally incorporated AIs only.

2/ Combined positions of all locally incorporated AIs and local offices of overseas incorporated AIs.

3/ Combined positions of all locally incorporated AIs, i.e. HKSAR offices plus overseas branches.

4/ Annual average spread between the Best Lending Rate and 1-month time deposit rate.

5/ HKSAR offices only.

Table 5. Hong Kong SAR: Banking Sector Stress Tests Summary, 2002 1/

Stressed Items		"Asian Crisis" Scenario 2/	Hypothetical Scenarios			
			# 1	# 2	# 3	# 4
Residential mortgage lending	Loans in negative equity	Property prices ↓ by 25%	Property prices ↓ by 20%	Property prices ↓ by 20%	Property prices ↓ by 30%	Property prices ↓ by 30%
	Prob. of default on loans in neg. equity	2.2% 3/	15%	15%	15%	20%
Credit cards	Charge-off	↑ by 18% (from 2.4% to 2.8%)	↑ by 25%	↑ by 50%	↑ by 100%	↑ by 150%
Other loans	The remaining loan balances	Classified loans ↑ by 92%, (from 2.1% to 4.1%) 50% specific provision	Classified loans ↑ by 25% with 50% specific provision	Classified loans ↑ by 50% with 50% specific provision	Classified loans ↑ by 100% with 50% specific provision	Classified loans ↑ by 120% with 50% specific provision
Off-balance sheet exposures	Outstanding volume of the exposures	Classified exposures ↑ from 0.2% to 1.0%, 25% specific provision	The same increment as for the "other loans", 50% specific provision	The same increment as for the "other loans", 50% specific provision	The same increment as for the "other loans", 50% specific provision	The same increment as for the "other loans", 50% specific provision
Interest rate risk 4/	Prime rate	↑ By 125 BP	↓ By 100 BP	↓ By 200 BP	Unchanged	Unchanged
	Savings deposit rate	↑ By 125 BP	Unchanged	Unchanged	↑ By 200 BP	↑ By 400 BP
	HIBOR	↑ By 260 BP on average	Unchanged	Unchanged	↑ By 200 BP	↑ By 400 BP
	Time deposit rate	↑ By 260 BP on average	Unchanged	Unchanged	↑ By 200 BP	↑ By 400 BP
Operating profit before provision	Non-interest income (nII) and net interest income (NII)	↓ According to indiv. Declines in 97/98, or the average of 20.6% ↓ in nII and 4.7% ↓ in NII, whichever is higher	↓ According to the 97/98 scenario, or 10% decrease in nII and 5% ↓ in NII, whichever is higher	↓ According to the 97/98 scenario, or 20% decrease in nII and 5% ↓ in NII, whichever is higher	↓ According to the 97/98 scenario, or 30% ↓ in nII and 5% ↓ in NII, whichever is higher	↓ According to the 97/98 scenario, or 40% decrease in nII and 10% decrease in NII, whichever is higher
After-shock CAR (in percent)	Overall	14.0	14.7	14.1	12.5	10.2
	Individual banks	11.1-111.6	11.3-117.2	11.4-117.2	9.6-111.5	7.4-106.1
Number of banks with CAR below	0 percent	0	0	0	0	0
	8 percent	0	0	0	0	3
	10 percent	0	0	0	2	4

1/ The stress tests were performed for 31 "retail banks" (27 local and 4 foreign), together accounting for about 80 percent of banking system's assets.

The impact of the shocks is measured over a period of 12 months, based on banks' positions as of end-June 2002. The hypothetical scenarios also assumed that HKSAR banks' exposures to a large failed company from the Mainland (GITIC) are 100 percent classified and 70 percent specific provisioning is applied to the exposures. Risks arising from changes in equity prices are not reported here, since they were found to be insignificant. Risks arising from changes in exchange rates and from interbank exposures were addressed in separate stress tests, summarized in the text.

2/ A stylized set of shocks in key variables, corresponding to the actual changes between June 1997 and June 1998.

3/ Derived from an estimate by the HKMC that a cumulative probability of default over 5-7 years of residential mortgage loans in negative equity is 13 percent. The current default rate on mortgages stands at about 1 percent.

4/ BP stands for "basis points."

64. **The interbank market does not seem to be a significant channel of contagion.** The authorities have performed interbank market contagion stress tests, based on a methodology proposed by the mission. The stress tests assessed the impacts of an individual bank's failure to pay its obligations on other participants in the interbank market. The results suggest that the failure of a single bank and the contagion effects would not create major disruptions in the interbank market.

65. **However, with the changes in the banking system's operating environment, a number of new risks and potential vulnerabilities arise.**

- ***The weak state of the domestic and global economy has started to encroach on banks' core profits.*** Increased provisioning, especially for credit card debt, and declining residential mortgage rates contributed to a decline in core profitability of some banks. The impact appears to have been greater on small banks.
- ***Direct exchange rate risk of banks is negligible.*** Stress tests for exchange rate risk, conducted by the staff, indicated that banks' direct vulnerability to exchange rate movements is very limited, since they generally maintain small open positions in foreign exchange. Moreover, the aggregate net open foreign exchange positions are long, meaning that the immediate direct effect of a depreciation of the exchange rate is likely to be positive.
- ***The full impact of the property price declines is yet to be seen, although banks presently appear well positioned to withstand further declines.*** Conservative loan-to-value requirements and loan service to income ratios have mitigated the effects of the decline in values. However, a significant proportion of bank mortgage books (the largest single component of bank lending) is showing negative equity. Thus, the inherent risk of the mortgage portfolios has increased, while competition among banks has brought down mortgage lending rates significantly. So far, the mortgages default rate has remained very low, but it could increase if residential prices continue to decline; nevertheless, stress tests suggest that banks would be able to withstand moderate increases in the rate of default (Table 5). The recent establishment of insurance mechanisms, and a secondary market for mortgages should help reduce the risk of further price declines on bank balance sheets.
- ***Credit risk is the factor to which the banks are most sensitive.*** With real estate prices declining, banks are trying to reduce their reliance on collateral, and instead perform a better assessment of the economic prospects of their clients.<sup>5</sup> However, there is still room for improvement, as indicated by the rapidly increasing credit card delinquency

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<sup>5</sup> The rising trend in the share of banks' loans to the property sector in total loans (Table 4) is largely a reflection of the decline in Euroyen loans booked by the Japanese banks in HKSAR; the actual volume of property lending has declined for the banking system.

(the credit card charge-off ratio increased from 3.8 percent in 2000 to 13.3 percent in 2002). At the same time, information is limited (both for supervisors as well as for some banks) about foreign exchange positions of banks' corporate clients and on banks' indirect lending exposures to the Mainland (mainly through HKSAR-based borrowers). The mission recommended that priority be given to improving the database so that potential vulnerabilities in these areas can be better assessed.

66. **The risk profile differs for large and small banks.** While most of the large banks are well diversified internationally, the small banks are intrinsically linked to the domestic economy.

- **Large banks have so far been a source of stability to the system.** However, the global nature of their operations may also present a potential contagion risk, since a sharp deterioration in economic conditions, or the health of financial institutions abroad, can have spillover effects on HKSAR subsidiaries.
- **Small banks are more exposed to domestic sources of risks, in particular the weak economy and property prices.** They are more likely to be affected by the increased intensity of competition, and less likely to have sufficient capital to enter the Mainland market. The small banks therefore have the option to either see their market share shrink even further, or to pool their resources, either by mergers and acquisitions, or in other forms (for instance, six small banks recently formed an insurance company as a joint venture).

67. **Another potential source of vulnerability is the absence of corporate reorganization legislation.** Provisions providing support for corporate rescue and reorganization are largely absent from the CO, despite recent attempts at reform. In the financial context, the BO provides for the appointment of a manager to conserve assets. This should also facilitate rescues, though it may not be a complete solution as regards the non-deposit-taking side of an FI's business, and does not override the insolvency process. Financial institution insolvency in the context of financial conglomerates also raises questions of coordination between regulators, as is shown by a number of "public interest" winding up powers scattered through the law. In 1999, a Law Reform Committee on Insolvency recommended an amendment to the CO to make it easier for the regulators to select the correct power but this recommendation has still to be enacted.

## **B. Insurance Sector**

68. **Risk levels within the life insurance sector are difficult to estimate because of lack of data available under the current delegated supervision approach** (see also Part II). The OCI conducts stress tests on an ad hoc basis, particularly after sudden adverse swings in the asset markets. In addition, all authorized insurers are required to carry out annual resilience tests at the corporate level and set aside provisions consistent with insurance regulations.

69. **The following practices pose potential risks for the life insurance sector:** products with Hong Kong dollar embedded guarantees that cannot be easily matched with available investments; lack of prescribed rules to limit the asset mix that companies can hold, even though the statutory solvency is based on the EU liability approach; different approaches to valuation and capital needs for retirement and standard life business, even when policy terms are effectively identical; accounting rules are not well defined for life contracts, and branches of foreign insurers can use the financial reporting basis that applies in their home country, provided that such basis is acceptable to the IA; and, assets of companies operating in HKSAR can be held anywhere, and thus may not be easily attachable to HKSAR policyholders in the event of an insolvency. OCI has proposed a study to consider means of dealing with these issues.

70. **The non life sector also presents problems.** The sector is dominated by statutory and property lines, both of which are subject to recent international reinsurance price increases and capacity shortages (particularly for terrorism risk). As in other countries the HKSAR government has had to provide interim support. The statutory classes have also seen large price increases, with the price of employees' compensation (EC) insurance doubling over the last two years. The supervisor has taken action to mitigate these price swings through requiring actuarial determination of technical provisions. The OCI considers that pricing should be determined by market forces. While these measures should overcome to a certain extent the information and disclosure problems inherent in long tail statutory classes, international experience indicates that more detailed publicly available pricing information may be necessary in the HKSAR for the market to become more efficient and stable. At present the requirement for actuarial intervention only applies to statutory long tail classes, although the IA is considering extending this to other liability classes.

71. **Around 10 percent of mortgage loans written by banks are now supported by mortgage lenders insurance.** While delinquency rates have been low, the growing role of insurers in accepting this risk on behalf of lending institutions suggests that the Mortgage Insurance Program (MIP) operated by the HKMC, should be established as a separate, specially-licensed insurer, with an appropriate level of capitalization. The HKMC is operating the MIP as an insurer, and is subject to the supervision of the OCI, which applies the U.S. standard in testing the capital adequacy of such insurers, but this has yet to be given a formal legal status. In addition, the OCI has issued a Guidance Note on Reserving for Mortgage Guarantee Business regarding the need to maintain a contingency reserve. The legislation should be amended to include a special section covering mortgage lenders and other credit-related insurance classes.

72. **Any systemic risks from the insurance sector would most likely manifest themselves through linkages to the banking sector, which are recent and manageable to date, but have been growing.** The key linkage that needs to be monitored is the impact of embedded guarantees in life insurance and pensions products, which might become a non-trivial part of a bancassurance group's portfolio. Further moves by banks' non-life affiliates into commercial and liability classes should be carried out under a supervisory regime with appropriately defined capital requirements.

73. **Insurance supervision faces a number of issues** (also see Part II). The assessment of HKSAR's observance of *IAIS Insurance Core Principles*, and the respective transparency practices suggests that the institutional and governance framework of OCI needs to be more clearly defined, and the supervisory capacity strengthened at the technical level. Accounting guidelines for life insurance need to be developed and brought up to international practices. While the OCI has done a commendable job of establishing the network of insurance related self-regulatory organizations, it needs to enhance its oversight role and make it more explicit. The requirements to be approved as an Appointed Actuary also should be clarified and include minimum experience, local knowledge and stochastic modeling abilities.

### C. Pension Funds

74. **The introduction of the MPF and the establishment of the MPFA have had a good start.** The MPFA has installed a strong regulatory and supervisory system, and fosters the roles of trustees, investment managers, and other professionals required for a self-supervisory approach. Subject to the severance and long-service pay issue, it ensures that the scheme members' assets are separated from those of employers and service providers. Investment rules have been established on a prudent-man basis and self-investment is controlled.

75. **The disclosure of MPF costs and risk return tradeoffs is inadequate and its cost structures are complex.** A number of MPF providers appear to be non-viable, which implies a need to facilitate an orderly exit.<sup>6</sup> Moreover, several emerging issues with the design of the MPF were identified, including: (1) a longer term need to provide vehicles to convert lump sum payouts to retirement incomes; (2) benefits are unlikely to be adequate to provide sufficient retirement income for most participants (participants need to be made fully aware that their MPF benefits will need to be supplemented by private savings). The cost and structure of the MPF system should be formally reviewed by MPFA before end-2004 to determine its sustainability in its current form. In this regard, a review of the disclosure of fees and charges and investment performance of MPF funds is being carried out by the MPFA and is expected to be completed by end-2003.

76. **Defined benefit plans (DBPs) continue to be important and will affect corporate reporting in the future.** Reportedly, a number of DBPs have been found to be in deficit, based on actuarial work under SSAP 34, but not necessarily under the MPFA reporting requirement. The decline in equity prices has also contributed to the deficit, similar to the recent international experience of less than minimum required funding levels.

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<sup>6</sup> The assessment of the pension sector was carried out on the basis of the draft OECD-International Network of Pensions Regulators and Supervisors (INPRS) Principles for the regulation of private occupational pensions schemes. These largely relate to the efficiency of the pension system, including financial sustainability, governance and delivery.

#### **D. Securities Market Regulation**

77. **The securities market is well supervised by the SFC, under a market-focused regulatory approach.** Trading systems, contingency plans, and stress testing are robust. Efforts have been made in recent years to codify the regulation of securities markets in HKSAR and adopt practices suited to the local conditions but with an eye to the comparative regulatory requirements in Australia, the U.K., and the U.S. Regarding oversight of regulatory agencies, the SFC enjoys operational and budgetary autonomy, but a number of 'checks and balances' infringe the IOSCO principle on independence. Also, improvement is needed in the quality of disclosure by listed companies and quality of compliance with internationally accepted accounting standards (see Part II for details).

78. **The key challenges to the securities regulator are the emerging cross-market risks.** Banks in HKSAR, which are subject to HKMA supervision, have developed a significant and growing share of the overall turnover of securities activity based in part on their wide coverage of the retail investor base. While at present this business is small compared to the overall size of the banking sector, their involvement in securities activities on behalf of retail investors may pose reputation risk if the products sold are inappropriate or perform poorly. Customers who also maintain other accounts with the bank might withdraw their business, or prospective clients may direct their business elsewhere. The SFC and the HKMA recognize the need to coordinate their supervision to ensure the same standards are applied. Consistent with the international nature of HKSAR's securities markets, the SFC has developed sound information-sharing arrangements with the HKMA and with foreign regulators, including some offshore centers.

79. **The brokerage industry in HKSAR is likely to consolidate further, but it is unlikely to pose a systemic problem.** The number of brokers is likely to decline as brokers face stronger competition from banks, mainly for retail bank customers. The SFC has intensified its work in assessing risk from operating losses if turnover remains low, and risk from margin financing if the value of collateral drops further in the event that the stock market and economic growth sustain a significant further decline. Its stress tests indicate that some marginal brokers may fail but that the sector is well capitalized and cushioned against adverse developments.

80. **The strengthening of financial and economic ties with the Mainland poses a regulatory challenge for HKSAR's future role as an IFC.** One such area is the increasing capital formation activities of Mainland companies; 80 percent of capital raised by Mainland companies outside of the Mainland is in HKSAR. More generally, regulatory issues in the securities markets are likely to arise as investment banking (corporate finance, sales and trading, and principal investment) is conducted with the Mainland by HKSAR-based financial institutions.

## **E. Payment and Securities Settlement Systems**

81. **In the area of payment systems, the Hong Kong dollar RTGS was found to be efficient and reliable, and the liquidity risks associated with the system well monitored and managed.** The mission assessed HKSAR's observance with the CPSS *Core Principles for Systemically Important Payments Systems* (CPSIPS) and found that the HKMA is continuing to strengthen the operational reliability and efficiency of the payment systems. At the same time, however, the mission noted that an important policy priority is a new law to give greater clarity and statutory foundation to payments system oversight, including to ensure undoubted payments finality.

82. **A key challenge arises from HKSAR's role as a multicurrency clearing center of Asia.** It has a well-developed U.S. dollar clearing system, and there are plans for euro clearing and, tentatively, yen clearing facilities. Weaknesses were found in the following areas: (1) ensuring undoubted finality; (2) the legal basis for payment systems oversight; (3) in payment system oversight and policy transparency, balancing stability considerations against the objectives of developing new payment systems infrastructure; and (4) insufficient resources devoted to payment systems policy development. It is also recommended that the U.S. dollar clearing system be treated as a systemically important payment system, and that the CPSIPS be applied to the system.

83. **HKSAR's securities operations are efficiently supported by the settlement system and the legal framework supports securities custody, clearing and settlement well.** The technical infrastructure is efficient and robust. As noted above, early approval of the pending legislation to exempt designated clearing and settlement systems from the operation of insolvency law, as is already the case for the recognized clearinghouses is strongly supported. At the *governance and oversight* level, greater participation of the stakeholders and greater involvement of the HKMA in the oversight of the securities settlement systems (as a complement to its role as the overseer of the payment systems), and enhanced cooperation between SFC and the HKMA are recommended (also see Part II).

## **F. Market Foundations, Market Integrity, and Safety Nets**

### **Corporate governance practices**

84. **In the past two years, HKSAR has renewed its commitment to improving corporate governance.** Substantial progress has been made to strengthen laws and practices and a number of consultation papers and reforms have been initiated. The new Securities and Futures Ordinance (SFO) contains measures to enhance corporate governance and the protection of shareholders. The pending amendments' bill to the Companies Ordinance (CO) introduced into the Legislative Council (LEGCO) in January 2002 also seeks to enhance shareholders' rights and clarify directors' duties.

85. **The key challenges in the corporate governance area relate to the ownership structure in the corporate sector.** Corporations in HKSAR are often controlled by families. Almost 90 percent of listed companies have one shareholder or one family group of



shareholders owning 25 percent or more of the issued capital. Fifteen of the largest 20 companies in HKSAR are under family control, and ten families control approximately one third of the corporate sector. The widespread use of pyramid structures, cross-shareholdings and offshore vehicles makes the ownership structure opaque and poses risks for the rights of minority shareholders.

**86. Corporate governance problems also highlight the need to strengthen investor confidence.** Where compliance is weak, enforcement of law and regulation is not always perceived to be forceful enough. The enforcement powers under the listing rules available to SEHK arise out of the contractual obligation between the SEHK and the issuer, and violations cannot be pursued in a court of law. There is a need for fostering shareholder participation, ensuring equitable treatment of minority shareholders, improving the frequency and quality of reporting, and enhancing board oversight (see also Part II).

**87. The three-tier capital market regulatory system leads to a lack of clarity of regulatory roles, and a perception of weak enforcement.** Furthermore, there is an inherent conflict of interest for a demutualized stock exchange to retain its front-line regulatory function for listed firms. Following the release in March 2003 of an expert review of the operation of the securities and futures market regulatory structure, and consistent with FSAP recommendations, the government indicated that it would keep the matter relating to SFC and HKEX under review, including considering the removal of the listing function from Hong Kong Exchanges and Clearing Limited and transferring it to the SFC. Prompt action is needed on this proposal.

#### **Accounting and auditing practices**

**88. The Hong Kong Society of Accountants (HKSA) has adopted an active policy of harmonization of HKSAR's accounting standards with International Accounting Standards (IAS).** The HKSA issues Statements of Standard Accounting Practice (SSAP), and certifies and regulates accounting professionals. While SSAPs lack statutory backing, the HKSA requires compliance with them by members. The CO makes detailed provision for the form and content of financial statements and their audit, while the SEHK specifies the accounting standard frameworks acceptable for listed companies and the disclosures required for reconciling them to HKSAR SSAPs. HKSAR's auditing standards are based on International Standards of Auditing and there are no significant differences between the two.

**89. Overall, the accounting and auditing practices in HKSAR are adequate to support a market-based financial system.** The disclosure framework is sound and the legislative, regulatory, and professional inputs to maintain the framework cooperate well. Among the sector-specific issues are life insurance accounting standards. Improving the standards would require: (1) completing convergence of HKSAR accounting standards with IAS, which would, *inter alia*, improve disclosures of risk management practices, fair values, hedging, and derivatives; (2) establishing a common financial statements disclosures compliance body; (3) requiring clearer evidence of auditor independence; and (4) enhancing transparency and effectiveness of the disciplinary procedures in case of misconduct.

## **Anti-Money Laundering and Combating of Financing of Terrorism**

90. **The regulatory and supervisory framework relating to AML/CFT measures is generally in observance with the *IMF/World Bank AML/CFT Methodology*.** The HKSAR has achieved a very good standard of compliance with the FATF 40+8. In the banking area, laws, regulations, and mandatory guidance notes are adequate and onsite inspections by the HKMA appeared to be sufficient to ensure adequate compliance. All locally incorporated banks as well as their branches or subsidiaries abroad, and foreign banks' HKSAR entities, are subject to a comprehensive set of statutory rules to reduce risks stemming from money laundering and fraudulent activities in and against the banks.

91. **Several weaknesses in the AML/CFT were identified; the authorities are aware of these weaknesses and are taking steps to address them.** The weaknesses include: (1) inadequate oversight of remittance agents and money changers; (2) inadequate resources of the Joint Financial Intelligence Unit; (3) difficulties in ascertaining customer identification in the case of shell companies; and (4) problems in the quality of suspicious transactions reports.

### **G. Regulatory Governance**

92. **Regulatory agencies in the HKSAR have played a key role in maintaining the strength of the financial system and are working towards promoting good governance practices in the institutions under their oversight.** However, governance practices relating to the *regulatory agencies themselves* vary across sectors. Of the four widely recognized elements that help ensure the practice of good regulatory governance, i.e., *independence, accountability, transparency, and integrity*, the first three elements need enhancement.

93. **The key areas for improvement relate to institutional aspects of agency independence, and to accountability systems for regulatory policies and supervisory performance.** As regards *independence*, the MA and the IA are individuals in law, and appointed by the FS and the CE of HKSAR respectively. The procedures for appointment, terms of office, and grounds for dismissal of the heads of the principal regulatory and supervisory agencies are not specified in legislation. Furthermore, unlike the MA and the HKMA, the IA and the OCI are part of the Financial Services and the Treasury Bureau and, hence, directly part of HKSAR government. As such, the insurance supervisory function is not independent. The independence of the principal regulatory and supervisory agencies is also limited by the lack of a prescribed framework within which the CE can exercise powers to issue binding directions in all areas of financial policies and to exempt, modify, or vary the provisions of the insurance companies ordinance as they apply to any insurer; also, conditions are lacking on the FS's power to exempt any person from the provisions of the BO. Although subject to judicial review, the existence of these relatively unconditioned powers could affect the institutional credibility of the principal regulatory and supervisory agencies. The procedures for appointment, terms of office, and grounds for dismissal of the Monetary and Insurance Authorities, and the members of the EFAC should therefore be specified in legislation and publicly disclosed. The criteria for exercising the power of the

Chief Executive to remove from office the SFC's chairman and members of the Board of Directors should also be specified in legislation and publicly disclosed.

94. **As regards *accountability*, the MA and IA are personally responsible and accountable for carrying out the responsibilities and achieving the objectives of banking supervision and insurance regulation respectively.** The HKMA and the OCI do not have governing boards to oversee the day-to-day exercise of their functions in the areas of banking supervision and insurance regulation. The right of appeal in the areas of banking supervision, securities, and insurance regulation is required to go from one branch of the executive to another (the CE, in consultation with the Executive Council, in the case of banking supervision, and the FS in the case of insurance regulation). However, a more conventional tribunal system will, operate in the case of securities regulation under the new SFO's provisions.

95. **The common presence of the reserve power of the Chief Executive of the HKSAR to give directions to statutory bodies, including all financial regulators, reflects the executive-led nature of the HKSAR government under the Basic Law.** Articles 109 and 110 of the Basic Law vest the responsibility for regulation of financial markets to the Government. Accordingly, the FSAP team recognizes that some reserve power for the CE as regards regulation of financial markets is appropriate under the government's constitutional responsibilities. The government has reassured the FSAP team that the government sees the CE's reserve power only as a tool of last resort for implementing necessary measures in extreme situations. This interpretation of the circumstances in which the CE will use the power to direct, however, is not publicly disclosed. To better meet the requirements for operational independence of the principal regulatory and supervisory agencies, stipulated in the relevant international standards, and improve the transparency of the institutional framework for formulation of financial policies, as required by the IMF's Transparency Code, the HKSAR government should clarify the circumstances under which the reserve power of the CE to direct financial regulators will be exercised.

96. **In the medium term, consideration should be given to the introduction of qualifications on the use of the reserve power in the areas of banking and insurance supervision similar to those included in the new Securities and Futures Ordinance.<sup>7</sup>** The conditions under which the CE can exempt, modify or vary, in consultation with the Executive Council, the provisions of the Insurance Companies Ordinance as they apply to any insurer, and on the exercise of the FS's power to exempt any person from the provisions of the BO should be limited to decisions that have public policy, systemic or strategic

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<sup>7</sup> Section 11 of the SFO places checks on the CE's power to give written directions to the SFC. Accordingly, such a power may only be exercised subject to the following restrictions: (1) the direction must be in the public interest; (2) it must further the SFC's regulatory objectives or the performance of any of its functions; and (3) the Chief Executive must first consult the Chairman of the SFC to formally afford SFC a chance of being heard.

implications and there should be full and timely disclosure of the use of these powers. The lack of definition in the law of the status, board structure, resources, staffing and effective accountabilities of the OCI could be addressed by the granting of the OCI of formal and separate independence. In addition an independent funding capacity should be developed in parallel with a move to a more independent statutory status.

97. **Cross-market and cross-border regulatory issues are gaining more importance in HKSAR.** In this context, HKSAR has been developing a more holistic approach to coordinating system-wide issues by adopting systems suited to HKSAR conditions. The main coordinating bodies are the *Council of Financial Regulators*, which provides a forum for financial regulators to discuss high level financial sector issues; the *Financial Stability Committee*, which monitors events across the securities and derivatives markets, banking sector and money market and coordinates efforts to minimize systemic implications of any of these events for HKSAR's financial markets as a whole; and the *Risk Management Committee* of HKEX, which monitors and controls risks in stock and derivatives markets. The SFC and the HKMA have adopted a lead regulator approach to the supervision of financial groups that include both banking and securities activities. The arrangements are set out in a memorandum of understanding (MOU), and the two regulators meet regularly under that memorandum. There are also MOUs among the MPFA, HKMA, SFC, and OCI on MPF-related activities by various types of financial intermediaries.

98. **The regulatory governance arrangements are moving in the right direction; however they could be placed on a more formal and publicly accountable basis.** The regulatory and financial stability framework comprises a complex web of institutional arrangements and is strongly reliant on personal relationships and understanding at the level of the agency heads and the government. A clear statement of the financial stability policy framework with a publicly disclosed specification of the supervisory roles relating to managing system-wide stress appears desirable. It would also help minimize any perceived or actual conflicts of interest or lack of clarity during times of financial stress. In addition, it would better coordinate the available supervisory resources. While there have been no bank closures in the last ten years, there does not appear to be a clear division of responsibility between the regulatory authorities in the case of a threatened insolvency of an LCFI.

99. **Analysis of trends and vulnerabilities in the financial system is conducted on a sector-by-sector basis with individual line supervisors producing periodic reports.** Coverage of systemic and cross-sector issues could be enhanced through extending the collection and analysis of sector data. Cross-market exercises to test contingency planning and operating mechanisms have been introduced recently and are coordinated by the FSTB. This will help to better manage market innovations, the growing complexity of institutions in HKSAR, and address the moral hazard (too big to fail) risk arising from the dominance of a few LCFIs.

100. **The financial stability policy framework could be overseen by an enhanced Council of Financial Regulators.** It would have a coordination role, but no direct regulatory responsibility. As opportunities arise, the council could be provided a statutory basis to

enhance its public accountability, particularly relating to decisions taken during times of financial stress. Information and periodic reports could also be provided on HKSAR's financial stability framework, with reporting on the performance of the financial system and payment and securities settlement system oversight. A formal stability report could be issued that identifies the main trends and vulnerabilities across sectors, and in the financial system as a whole.

## PART II: OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES—SUMMARY ASSESSMENTS

This part contains summary assessments of adherence to eight international standards and codes applicable to the financial sector. The assessments have helped to identify the extent to which the regulatory and supervisory framework in the HKSAR is adequate to address the potential risks in the financial system, as well as the strength of the underlying regulatory governance practices and market foundations, and the functioning of market infrastructure. The assessments have provided the basis for making recommendations for further strengthening of the institutional, legislative and regulatory aspects of the financial stability framework.

The summaries are based on the *detailed* assessments undertaken as part of the FSAP by Messrs. Göran Lind (Sveriges Riksbank, Sweden) and Peter Phelan (ex-Financial Services Authority, United Kingdom) for the *Basel Core Principles for Effective Banking Supervision*; Ms. Eija Holttinen (Financial Supervision Authority, Finland) and Mr. Gregory Tanzer (Australian Securities and Investment Commission) for the *IOSCO Objectives and Principles of Securities Regulation*; Messrs. Rodney Lester (World Bank) and John Thompson (ex-Office of the Superintendent of Financial Institutions, Canada) for the *LAIS Insurance Core Principles*; Mr. Nicholas Roberts (Reserve Bank of Australia) for the *Core Principles for Systemically Important Payment Systems*; Mr. Yvon Lucas (Banque de France) for the *IOSCO-CPSS Recommendations for Securities Settlement Systems*; Ms. Eva Gutierrez and Mr. Plamen Yossifov (both IMF), with the sectoral experts, for the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies*; Ms. Mierta Capaul (World Bank) for the *OECD Principles of Corporate Governance*; and Messrs. Richard Gordon and Nadim Kyriakos-Saad (both IMF), with Ms. Linda Samuel (independent expert from the U.S. Department of Justice) for the assessment of the *AML/CFT Standards*.

The assessments were preceded by self-assessments undertaken by the HKSAR authorities, which were evaluated during the FSAP, by focusing on actual practices, verified through discussions with HKSAR authorities, market participants, industry associations, and self regulatory organizations. The findings were cross checked with quantitative information available on the websites, and relevant laws and regulations.

HKSAR's adherence with international financial sector standards and codes is very strong, even though in each area, certain aspects were identified where further improvements would be desirable, mostly reflecting the role of HKSAR as an important international financial center.

The HKSAR authorities are well aware of the areas for further reforms and have been addressing the priority issues. They have acknowledged that the process of self assessments and the subsequent FSAP assessment has helped to identify some key issues relating to governance practices, formal mechanisms of supervisory cooperation, cross-market risks which could affect medium term stability, and transparency. Revisions to the existing arrangements are being implemented that will help to further strengthen the financial stability framework.

## V. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

101. The assessment of compliance with the Basel Core Principles for Effective Banking Supervision was based on the Basel Committee's Methodology for the Assessment of the Core Principles. Compliance was assessed against the "essential" as well as the "additional" criteria. The assessors applied the discretion provided by the Methodology to undertake an assessment taking into account specific features in the HKSAR affecting the financial system. HKMA cooperated fully with the assessors and provided all the necessary clarifications and supporting documents. As prescribed in the Methodology, the assessment was based on the supervisory system and practices as in place at the time of the assessment. (October 2002). Whenever relevant, more recent developments and plans for amendments have been described.

### **Institutional and macro-prudential setting<sup>8</sup>**

102. The banking system plays a key role both in the HKSAR's economy and in the region, and accounts for two thirds of total assets of the financial system. The banking system includes a large number of institutions, but it is highly concentrated and has a quasi-oligopolistic structure.

103. The banking system has shown considerable resilience to shocks in the past, but faces new challenges in the future. So far, it has remained relatively strong, with high profitability, liquidity, and capital adequacy ratios, and a low level of classified loans. However, the weak state of the domestic and global economy has started to encroach on profits in some banks. Current pressures on residential mortgage rates and a reduced demand for borrowing compel banks to search for alternative revenue sources. There is an increasing tendency for banks to move into cross-market products and services, such as securities, insurance, and pension fund management.

### **General preconditions for effective banking supervision**

104. Well functioning legal, accounting, and payments and securities settlements systems are in place. Financial institutions generally enjoy the legal protections that are necessary for banking business. The HKSAR is actively pursuing a policy of converging its accounting standards with international standards, while the absence of a standard for financial institutions has been mitigated by the HKMA imposing extra disclosure requirements. Auditing standards are in conformity with international standards, compliance being actively monitored by the HKSA, a well run professional association. The payments and securities settlement systems are in general very efficient.

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<sup>8</sup> See Part I of the FSSA report for more details.

105. Gaps exist in the insolvency regime, as there is no corporate reorganization legislation. Provisions providing support for corporate rescue and reorganization are largely absent from the CO, despite recent attempts at reform. In the financial context, the BO provides for the appointment of a manager to conserve assets. This should also facilitate rescues, though it may not be a complete solution as regards the non-deposit-taking side of an FI's business, and does not override the insolvency process. Financial institution insolvency in the context of financial conglomerates also raises questions of coordination between regulators, as is shown by a number of "public interest" winding up powers scattered through the law. In 1999, a Law Reform Committee on Insolvency recommended an amendment to the CO to make it easier for the regulators to select the correct power, but this recommendation has still to be enacted.

106. No deposit protection scheme (DPS) is in place, but a proposal has been drafted and discussed with the banking industry, insolvency practitioners, and other interested parties. At present, the only protection for depositors is priority in the event of bank liquidation. The authorities plan to introduce a limited "pay-box" type of deposit insurer, with activities largely limited to collection of fees, managing the deposit protection fund, and making payments as required. They intend to present the final bill to the LEGCO in early 2003 and envisage that the scheme becomes operational in 2005.

### **Main findings**

107. Overall, the HKSAR has a very high degree of compliance with the international best practices in banking regulation and supervision. The systems are also strong when taking into account the need for supplementary regulation and supervision, given HKSAR's role as an international financial center. The main areas for further strengthening apply to: (1) the governance of regulation and supervision; (2) measures for dealing with liquidity risk; (3) supervisory attention given to reputational risk and legal risk to banks; (4) cooperation with other supervisors (in particular with the insurance supervisor) to deal with risks stemming from cross-market activities in banks.

### ***Objectives, autonomy, powers, and resources (CP 1)***

108. Under present legislation, the Chief Executive may overrule and instruct the Monetary Authority in any matter governed by the Banking Ordinance. In addition, the CE in the Executive Council acts as the arbiter of appeals on decisions taken by the MA under the BO. The present powers of the CE have so far not been used to interfere in the operational decisions taken by the MA, but their presence poses a potential threat to supervisory independence.

109. While it is acknowledged that the CE should be involved in decisions relating to severe problem bank matters, possibly with systemic implications and with the involvement of public funds, he should not have the power to interfere in operational supervisory matters of lesser importance. As a first step, the government could issue a public statement outlining the circumstances under which the reserve power of the CE to direct financial regulators will



be exercised. In the medium term, consideration should be given to the introduction of qualifications on the use of this reserve power in the area of banking supervision similar to those included in the new Securities and Futures Ordinance.

110. Also regarding independence, the grounds and procedures for the dismissal of the MA should be made explicit and public.

***Prudential regulations and requirements (CPs 6–15)***

111. **Credit policy (CP 7).** Banks should continue their ongoing efforts to strengthen their evaluation of borrowers, including information sharing on borrowers' overall indebtedness and revenue sources. Authorities' plans for establishing a credit registration bureau for consumer credits should be enhanced to cover also credits to corporates. In the meantime, the HKMA should encourage banks to improve their present credit evaluation methods.

112. **Other risks (CP 13).** The present draft for updated guidelines on the management of liquidity risk in banks is welcome and should be implemented. The new guideline on interest rate risk management, issued in December 2002, will also add to sound management decisions. Specific guidelines covering reputational and legal risks should be issued, as well as a consolidated guideline on operational risks.

113. **Money laundering (CP 15).** Overall, HKMA has in place a comprehensive framework for customer due diligence and record keeping with respect to the accounts of AIs.

***Methods of ongoing supervision (CPs 16–20)***

114. **Off-site and on-site supervision (CP 16).** The HKMA should widen the scope of the newly created system of internal quality assessments to cover all aspects of its supervisory performance. **Consolidated supervision (CP 20).** The HKMA's unitary approach to supervision (i.e., supervising all branches and subsidiaries, be they locally incorporated or foreign) mitigates the potential risks related to offshore banking. Moreover, since the HKMA has begun conducting risk-based supervision on a consolidated basis, there are a number of checks-and-balances that facilitate the identification of specific risks posed by offshore banking activities. However, given the increasing cross-market activities of banks, arrangements for cooperation with other supervisory agencies (in particular, with the insurance supervisor) need to be enhanced. In addition, the HKMA should focus more on identifying risks stemming from new activities and new instruments in bank groups, including when they are conducted in subsidiaries or joint venture companies.

***Accounting issues (CP 21)***

115. Although the presently adopted standards for accounting provide a generally fair view of banks' financial standing, the HKSAR authorities are encouraged to continue to work on converging with the International Accounting Standards.

**Formal powers of supervisors (CP 22)**

116. The weaknesses mentioned under CP 1 above, relating to the powers of the CE and the FS, also influence the enforcement of the powers of the MA.

Table 6. Recommended Actions to Improve Observance of the Basel Core Principles

Reference Principle	Recommended Action
Objectives, Autonomy, Power, Resources (CP 1)	Issue a public statement outlining the circumstances under which the reserve power of the CE to direct financial regulators will be exercised. In the medium term. Restrict the role in operational supervision of the CE.
Credit Policy (CP 7)	Continue to encourage banks to strengthen credit granting policies to ensure that banks only grant credits based on full information about the financial strength of the borrower, his overall indebtedness, the structure of the borrowing organization, the collateral and the purpose of the loan and the sources of repayment.
Other Risks (CP 13)	Draft new/ enhance present risk management guidelines for liquidity risk; operational, legal, and reputational risks. Implement the new guideline on interest rate risk management.
On-site and Off-site Supervision (CP 16)	Upgrade the internal HKMA system for quality assessment of supervisory performance.
Consolidated Supervision (CP 20)	A more structured system of cooperation and harmonized regulation between different sector supervisors is needed.
Accounting Issues (CP 21)	Continue to work on convergence with the IAS, in particular IAS 32, 39, and 40.
Remedial Measures (CP 22)	Same recommendation as under CP 1 above.

**Authorities' response**

117. Overall, the authorities indicated that the assessment was generally fair, other than that on autonomy and power (CP 1) and consolidated supervision (CP 20). The authorities indicated that the reserve power vested in CE over the financial regulator is necessary to reflect the government's responsibility to formulate monetary and financial policies and regulate and supervise financial markets as enshrined in the Basic Law. Such power would only be used as a tool of last resort to implement specific remedial measures in the most critical and extreme circumstances. Despite CE's reserve powers under the relevant financial services legislation, our constitutional and political convention is such that these powers have never been exercised. This convention of restraint is so deeply embedded that any arbitrary attempt to abuse the power would be politically untenable as it would not be accepted by the stakeholders. Moreover, when exercising such power, the CE has to be satisfied that the direction must be in the public interest and consistent with the objectives and functions of the regulators. The CE must act within the confines of the Basic Law and comply with any relevant international obligations on the HKSAR. Given these qualifications, the authorities felt that it would not be appropriate to restrict the CE's reserve power further.

118. On the issue of appointment and dismissal of regulatory authorities, the authorities indicated that the persons who are empowered to make the appointment are all required under common law to act reasonably and take all relevant factors into consideration. Otherwise their decisions may be subject to judicial review. Relevant factors to be taken into account regarding appointment would include fitness for the office and those regarding removal would include serious failure of duty and grave misconduct.

119. Regarding the recommendations on other risks (CP13), the authorities felt that a fully-fledged liquidity regime (comprising statutory and prudential limits as well as a system for monitoring the liquidity positions of banks) is already in place. The updating of guidelines on liquidity risk should be seen as a part of the ongoing exercise to ensure that major risk management guidelines are in line with international standards and practices rather than as a main area for further strengthening. The authorities further believed that adequate supervisory attention has been given to reputational and legal risks under the risk-based supervisory framework. The nature of these risks has also been separately discussed in relevant guidelines (e.g. "General Risk Management Controls").

120. On consolidated supervision, the authorities felt that the assessment did not take sufficient account of the highly structured and coordinated system of cooperation that already existed between the HKMA and the SFC (to a lesser extent with the MPFA) and the recent actions that had been taken to further enhance supervisory cooperation among the authorities.

## **VI. IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION**

121. The assessment of HKSAR's securities regulatory system was based on its observance of the IOSCO Objectives and Principles of Securities Regulation. The assessment was done on the basis of IOSCO's implementation scale using the Guidance Note for

Assessing Implementation of IOSCO's Objectives and Principles of Securities regulation. The assessors took into account specific features in the HKSAR affecting the financial system, and the international character of the securities market.

122. The assessment is based on interviews with staff of the SFC, the HKMA, and the Financial Services Bureau; interviews with staff of self regulatory organizations (the Hong Kong Exchanges and Clearing Limited (HKEX) and related companies, and the Hong Kong Society of Accountants); a review of the laws, rules, guidance notes, consultation papers and procedures with respect to the securities industry; and the self-assessments provided by the SFC. In addition, representatives of the industry from the Hong Kong Investment Funds Association and Stockbrokers Association, as well as representatives from various licensees were helpful in providing the mission with necessary information.

123. The assessment is primarily an assessment of whether the legal and regulatory framework is in place to meet the requirements of the IOSCO Principles. The assessment did not attempt to evaluate fully the extent to which the framework in place is implemented by SFC programs and activities. However, the assessment did test the manner in which the SFC implements the principles and calibrate this against the experience of selected market

participants. As prescribed in the Assessment Guidance, the assessment is based on the regulatory system and practices as in place at the time of the assessment. The evaluation is therefore based on the laws, regulations and supervisory practices as of October 2002. Whenever relevant, plans for amendments have been described, including how the new SFO will modify the existing securities regulatory arrangements.

### **General preconditions for effective securities regulation<sup>9</sup>**

124. The general preconditions for an effective securities regulatory regime appear to be in place in HKSAR. There are no unnecessary barriers to entry or exit for market participants, the sector is competitive, and the markets are open to foreign participants. The legal system supports effective capital and credit regulation, with efficient court systems and bankruptcy and contract law. The legal framework has established a regulator with decision-making authority and clear responsibility and accountability. The rule of law is respected and supports enforcement of the law.

125. In recent years significant efforts have been made to codify the regulation of securities markets and adopt practices suited to the local conditions, and with an eye to the comparative regulatory requirements in the U.S., U.K., and Australia. The current legislative framework is comprised of a large number of ordinances. Over the last three years the SFC has been developing a more holistic approach to regulation, culminating in the enactment of the Securities and Futures Ordinance in March 2002.

126. HKSAR is seen as a low tax environment by international standards. There is broad acceptance of a common approach to accounting. The SEHK Listing Rules require that companies' financial statements comply with Hong Kong Statements of Standard Accounting Practice (HK SSAP) or IAS. For secondary listings in HKSAR, listed companies may comply with U.S. GAAP or, on special application, National GAAP with reconciliation to HK SSAP or IAS. The HK SSAP promulgated by Hong Kong Society of Accountants (HKSA) is progressing to harmonization with IAS.

### **Main findings**

127. The securities regulatory regime in HKSAR is appropriate to the requirements of the domestic market and also conforms to most international securities regulatory best practices. The regulatory agencies involved in securities markets (principally the SFC), are well-resourced, professionally staffed, and have adequate surveillance, inspection and enforcement powers. The infrastructure for a well-functioning securities market, including an efficient trading, clearing and settlement system and appropriate listing rules and procedures, is in place.

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<sup>9</sup> Also see Part I of the FSSA report for more details.

128. There are, however, several aspects of the regulatory framework which can be improved upon and strengthened. The primary deficiency relates to some of the governance related practices, which could be further strengthened. A lack of clarity exists about the role and responsibilities of the Financial Secretary, and to a lesser degree the Chief Executive of HKSAR, with respect to some important regulatory decisions. While in practice, the SFC enjoys full operational autonomy, the existence of these reserve powers to intervene are not in step with the prevailing best practices in significant securities markets. In addition, the SFC and the HKMA play a direct role in the risk management processes of the HKEX through membership on its Risk Management Committee, and both HKEX and the SFC play a role in ensuring compliance with the disclosure obligations of listed companies. There is therefore a potential for some confusion in terms of primary responsibilities and the accompanying accountability, which should be clarified.

129. Cross-market risks are growing in response to global trends and domestic conditions. Banks, which are subject to HKMA supervision, have developed a significant and growing share of the overall turnover on the SEHK. While the securities business is still small compared to the overall size of the banking book, the involvement of banks in securities activities on behalf of retail investors is rising, and may pose reputation risk if the products sold are inappropriate or perform poorly. Customers who also maintain other accounts with the bank might withdraw their business, or prospective clients may direct their business elsewhere. The SFC and HKMA recognize the need to further strengthen their supervision to ensure the same standards are applied, at both the prudential and the conduct of business levels.

#### *Regulator (Principles 1–5)*

130. In practice the SFC operates independently in the discharge of its functions, is well-resourced and is subject to a range of appropriate accountability measures. It has substantial budgetary autonomy, and has not received direct Government funding for over eight years. However, the power of the Chief Executive of HKSAR to give a direction to the SFC about any matter relevant to the performance of its functions is inconsistent with its statutory role as an independent securities regulator. There are a significant number of decisions on which the SFC must consult or seek the consent of various bodies. Some of these requirements are inconsistent with the independent functioning of the SFC, and impair its ability to act quickly in an emergency situation. Any direction given by the Chief Executive should be required to be published, and the need for the SFC to consult on or seek the consent of other parties to what are essentially regulatory decisions should be reviewed. The criteria set down in the law for removal of the SFC's chairman and members of the Board of Directors should be clarified. The new SFO partly deals with this problem.

131. The SFC's practice of issuing private reprimands should be used sparingly so that the market can be confident that the SFC is acting consistently and transparently. Directors and staff of the SFC should be explicitly required to disqualify themselves from participating in decisions in which they have an interest.

***Self-regulatory organizations (Principles 6–7)***

132. The HKEX forms part of a regulatory system where the responsibilities of the Financial Secretary, the SFC and the HKEX overlap in many cases. This is most evident in the case of the Risk Management Committee of the HKEX, which includes the Chairman of the SFC and the Chief Executive of the HKMA. This lack of clear division of responsibilities between these regulatory and self-regulatory authorities could lead to problems with determining accountability for various types of decisions. This arrangement is also quite peculiar considering that the HKEX is a publicly listed, for-profit exchange which would normally make its own business decisions including deciding on the appropriate methods to manage its risks. The need for maintaining this arrangement should be reviewed.

133. The current system of regulation of listed companies, including disclosure, which involves a split responsibility between the SFC and the HKEX is under review in HKSAR. The powers available to SEHK to discipline companies for poor disclosure are relatively limited, and rely on the contractual relationship between the company and the exchange. The SFC and the SEHK should give increased attention to monitoring compliance and taking enforcement action in appropriate cases. Given the importance of accurate financial disclosure by listed companies to market integrity, the HKSAR authorities should consider assigning a public oversight body to oversee the activities of the HKSA.

***Enforcement (Principles 8–10)***

134. The SFC has comprehensive powers of inspection, surveillance and investigation of regulated entities, which will be enhanced with the implementation of the new SFO. It devotes considerable resources to the inspection of regulated intermediaries, targeting those intermediaries that objectively pose higher risks. It conducts active market surveillance on a real-time basis, and has adequate linkages between its surveillance and inspection processes, and its enforcement processes. There are a number of technical limitations on the SFC's enforcement powers that are being addressed in the new SFO.

***Cooperation (Principles 11–13)***

135. The SFC has been active in entering into MOU's and other agreements for sharing information with domestic and foreign regulatory agencies. Given the growing importance to the HKSAR securities markets of Mainland companies, the SFC's and other HKSAR authorities' capacity to obtain from and give to its Mainland counterparts investigative assistance will become increasingly important. Continuing attention needs to be given to these arrangements, including the arrangements for the enforcement of civil judgments, freezing of assets and the extradition of persons charged with criminal offenses against the securities laws.

***Issuers (Principles 14–16)***

136. While the basic disclosure requirements exist in HKSAR, they could be enhanced in several ways. The HKSAR statutory and market authorities should carefully consider

implementing more timely disclosure of listed issuers' announcements. Implementation of current proposals concerning periodic reporting by companies listed on the SEHK Main Board would enhance financial disclosure in HKSAR on the lines of international standards.

137. Some of the requirements and practices in HKSAR securities markets are not sufficient to safeguard the fair and equitable treatment of listed companies' shareholders. These issues relate mainly to some of the basic rights of shareholders and their possibility to effectively participate in listed companies' decision making. There are significant shortfalls regarding the compliance of the HKSAR accounting standards with the IAS, currently being addressed by the HKSA, concerning the recognition, measurement and disclosure of information about financial instruments. The mission has concerns about the perceived transparency of auditor independence and the ability for the HKSA to be perceived as independent in the auditor disciplinary process. The authorities may also wish to consider the formation of a central financial statement review authority that has the responsibility of determining compliance with all disclosure requirements and the powers to require restatement and to penalize breaches.

#### *Collective investment schemes (Principles 17–20)*

138. The SFC requirements provide comprehensive eligibility requirements for entities and persons wishing to operate a CIS within HKSAR. These requirements are monitored on an ongoing basis. The SFC's approach to authorizing foreign operators which meet the eligibility requirements means that many funds offered to HKSAR investors are domiciled in foreign jurisdictions. These funds pose particular challenges for the SFC, which has to rely on the "home" jurisdiction regulation of the CIS operator.

#### *Market intermediaries (Principles 21–24)*

139. The SFC has issued a comprehensive set of rules and guidelines covering intermediaries' internal controls, risk management and conduct of business. The SFC's supervision of intermediaries through its risk-based inspection program and review of various reports provided by the intermediaries appears to be adequate. There is presently a risk of loss to investors in the event that a broker fails during the period (four days) that the broker is permitted to retain cleared funds before passing them on to the client. The one day limit proposed in the new SFO is consistent with that provided in some leading markets.

#### *Secondary market (Principles 25–30)*

140. The SFC maintains close contact with the HKEX and its subsidiaries. Its supervisory activities vis-à-vis these entities are largely based on active ongoing supervision and information sharing as well as pre approval of the HKEX's rules. However, the SFC has currently only limited power to control clearing houses, once approved. Under the new SFO, this will be improved (also see the assessment of CPSS-IOSCO Recommendations for Securities Settlement Systems).

Table 7. Recommended Actions to Improve Observance of the IOSCO Objectives and Principles of Securities Regulation

Reference Principle	Recommended Action
Principles Relating to the Regulator (CP 1-5)	
Principle 2. The regulator should be operationally independent and accountable in the exercise of its functions and powers.	<p>Any direction given by the Chief Executive should be required to be published. This direction power should be restricted to matters of general policy.</p> <p>There are a number of decisions on which the SFC must consult or seek the consent of various parties. The need for retaining this consultation or consent procedure should be reviewed.</p> <p>The legislative criteria for removal of the SFC's chairman and members of the Board of Directors should be more specific and grounds for removal should be published.</p>
Principle 4. The regulator should adopt clear and consistent regulatory processes.	<p>The practice of issuing private reprimands should be avoided wherever possible so that the market can be confident that the SFC is acting consistently. The broad nature of the inquiry and the fact of a reprimand should be made public.</p>
Principles of Self-Regulation (CP 6-7)	
Principle 7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.	<p>The need for the Chairman of the SFC and the Chief Executive of the HKMA to be members of the Risk Management Committee of the HKEX should be reviewed.</p> <p>In light of global concerns about poor financial disclosure by listed companies the SFC and the SEHK should give increased attention to monitoring compliance and taking enforcement action in appropriate cases.</p> <p>Given the importance of accurate financial disclosure by listed companies to market integrity, the HKSAR authorities should consider assigning a public oversight body to oversee the activities of the HKSA.</p>
Principles for Cooperation in Regulation (CP 11-13)	
Principle 13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.	<p>Given the growing importance to the HKSAR securities markets of Mainland companies, the SFC's and other HKSAR authorities' capacity to obtain from and give to its Mainland counterparts investigative assistance will become increasingly important.</p>
Principles for Issuers (CP 14-16)	
Principle 14. There should be full, accurate and	The HKSAR statutory and market authorities should



Reference Principle	Recommended Action
<p>timely disclosure of financial results and other information that is material to investors' decisions.</p>	<p>carefully consider implementing more timely disclosure of listed issuers' announcements.</p> <p>The mission supports the changes proposed by the SEHK to periodic reporting since it would enhance the financial disclosure on the lines of emerging international standards.</p>
<p>Principle 15. Holders of securities in a company should be treated in a fair and equitable manner.</p>	<p>Some of the requirements and practices in HKSAR securities markets are not sufficient to safeguard the fair and equitable treatment of listed companies' shareholders. For further reference, see the assessment of observance of the OECD Principles of Corporate Governance.</p>
<p>Principle 16. Accounting and auditing standards should be of a high and internationally acceptable quality.</p>	<p>Significant shortfalls regarding the compliance of the HKSAR accounting standards with the IAS, currently being addressed by the HKSA, occur in some aspects of the recognition, measurement and disclosure of information about financial instruments. This is considered a material deficiency for a significant international financial center.</p> <p>The authorities may wish to consider the formation of a central financial statement review authority that has the responsibility of determining compliance with all disclosure requirements and the powers to require restatement and to penalize breaches.</p> <p>While the HKSA is proactive in monitoring compliance with accounting standards and audit quality, the mission has concerns about the perceived transparency of auditor independence and the ability for the HKSA to be perceived as independent in the auditor disciplinary process.</p>
<p>Principles for Market Intermediaries (CP 21-24)</p>	<p>[REDACTED]</p>
<p>Principle 23: Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.</p>	<p>There is presently a risk of loss to investors in the event that a broker fails during the period (four days) that the broker is permitted to retain cleared funds before passing them on to the client. The one day limit proposed in the new SFO is consistent with that provided in some leading markets.</p>
<p>Principles for the Secondary Market (CP 25-30)</p>	<p>[REDACTED]</p>
<p>Principle 26. There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.</p>	<p>The requirement to consult or seek consent of various parties or give written notices before taking specified action could have a negative effect on the effectiveness of the SFC's supervisory work of the HKEX and its subsidiaries, especially in emergencies or during a financial crisis (see Principle 2).</p> <p>There is currently limited power within the legislation to control clearing houses, once approved. Under the new SFO, the SFC's power to withdraw a clearing house's license will</p>

Reference Principle	Recommended Action
	be clarified, and the SFC will obtain the power to direct a clearing house's premises to be closed.

**Authorities' response**

141. The authorities indicated that the assessment was generally fair, other than that on Principle 2 regarding consultation with FS, reserve power of the CE and removal of SFC Chairman and members. On the first issue, the authorities indicated that when necessary (mostly during times of emergency), the Financial Secretary works in close cooperation with the SFC to ensure that there is no potential conflict. Thus, the requirement to consult certain decisions with FS, as per the law, does not, in practice, result in an impairment to act quickly.

142. On the second issue, the authorities indicated that the reserve power vested in CE over the financial regulators is necessary to reflect the government's responsibility to formulate monetary and financial policies and regulate and supervise financial markets as enshrined in the Basic Law. Such power would only be used as a tool of last resort to implement specific remedial measures in the most critical and extreme circumstances. Despite CE's reserve powers under the relevant financial services legislation, our constitutional and political convention is such that these powers have never been exercised. This convention of restraint is so deeply embedded that any arbitrary attempt to abuse the power would be politically untenable as it would not be accepted by the stakeholders. Moreover, when exercising such power, the CE has to be satisfied that the direction must be in the public interest and consistent with the objectives and functions of the regulators. The CE must act within the confines of the Basic Law and comply with any relevant international obligations on the HKSAR. Given these qualifications, the authorities felt that it would not be appropriate to restrict the CE's reserve power further.

143. On the third issue, the authorities indicated that the persons who are empowered to make the appointment are all required under common law to act reasonably and take all relevant factors into consideration. Otherwise their decisions may be subject to judicial review. Relevant factors to be taken into account regarding appointment would include fitness for the office and those regarding removal would include serious failure of duty and grave misconduct.

144. In relation to the recommendation on principle 4, the SFC has since October 2002 ceased the practice of issuing private reprimands. As regards Principle 7, the Chairman of the SFC and the Chief Executive of the HKMA are no longer members of the Risk Management Committee of the HKEX. With effect from March 6, 2003, a member each from the SFC and HKMA executive has been appointed to serve the RMC in their personal capacity. Also in March 2003, the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure published its report. The Report contained a number of recommendations on the regulation of listing matters. The Government considered that the general direction of the recommendations was appropriate and would enhance the quality of

the market. It will consult the community further on the recommendations in view of their far-reaching implications. Finally the 'dual filing' arrangement introduced on April 1, 2003 enables the SFC to investigate and take enforcement action under the Securities and Futures Ordinance against the disclosure of false or misleading corporate information.

## VII. IAIS INSURANCE CORE PRINCIPLES

145. The assessment of the HKSAR's insurance supervision practices was carried out on the basis of its observance of the IAIS Core Principles (ICP) for insurance supervision. The assessment was carried out using the ICP assessment Methodology. The level of observance was evaluated on the "essential" assessment criteria, taking into account HKSAR's role as an open international financial center. Some of the recommendations made to strengthen insurance supervision in HKSAR have therefore been made even if not specifically included in the essential ICP criteria. As prescribed in the Methodology, the assessment is based on the supervisory system and practices as in place at the time of the assessment. The evaluation is therefore based on the laws, regulations and insurance supervisory practices as of October 2002. Wherever relevant, plans for amendments have been described.

### **Institutional and macroprudential setting<sup>10</sup>**

146. The insurance industry has a long tradition with foreign companies operating in HKSAR. As of June 2002, there were 48 life insurers, 137 non life insurers and 18 composite insurers approved in HKSAR. The insurance industry has approximately 45,000 individual agents and brokers. One of the factors that affected the depth of the assessment and to better understand the risk profile of the insurance industry was the fact that comparative financial information was not always available for life insurance companies that operate in HKSAR. Some insurance companies report on their world-wide operations and others on their HKSAR business, making a comparison within and across the sector somewhat problematic.

147. The long-term (life) insurance market is dominated by branches of foreign companies, with significant operations around the world, and seven Bermudan companies that operate almost exclusively in HKSAR. The career agency system is the main distribution channel for life insurance companies. Long term premiums were HK\$ 56.9 billion in 2001, or around 4.4 percent of GDP. The non-life market is broadly based, with a large local insurer presence. These companies generally have a broader range of distribution channels including their own agents, agents of other companies, local brokers and international brokers. Non-life premiums amounted to about HK\$19.4 billion in 2001.

148. A unique feature of the HKSAR insurance market is the presence of self-regulatory bodies for insurance agents and brokers, and the supervisory reliance on such bodies. These groups monitor the activities of their members to ensure that they are in observance with the insurance ordinance and their own Codes of Conduct. The OCI has recently required that all

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<sup>10</sup> Also see Part I of the FSSA report for more details.

agents and insurance brokers pass a competency examination and begin a process of continuing professional development to maintain professional competence. A mandatory policy replacement disclosure process has also been instituted as of October 1, 2002, to reduce and control policy replacement activity. Both these initiatives should improve market conduct but it is too early to assess the impact of these changes.

149. The insurance market has been undergoing a structural change in the recent period with banks having acquired or begun subsidiary insurance companies, or entered into a strategic alliance with one of the existing insurance companies. This trend is expected to continue as banks increasingly offer insurance products through their branches. The banks are making a significant impact on the market with about 13,000 licensed insurance sales staff in their branch offices.

### **General preconditions for effective insurance supervision**

150. HKSAR generally satisfies the preconditions for effective insurance supervision: (1) ethical and professional lawyers and judges; (2) comprehensive, enforceable and consistent accounting standards; (3) a strong actuarial profession; and (4) strong and effective supervision of the banking and securities sectors. In this context, the legal system in HKSAR, based on British common law (although with a dual language approach), is well functioning and developed in comparison with other common law jurisdictions. Accounting standards are regulated by the Hong Kong Society of Accountants (HKSA), and local professional standards are being developed for convergence with international accounting and auditing standards. There are approximately 20,000 qualified accountants in HKSAR and the HKSA maintains a large and professional secretariat. The Actuarial Society of Hong Kong (ASHK) has nearly 200 Fellow level members, all of whom have internationally recognized actuarial qualifications. The ASHK is a member of the International Actuarial Association and has issued a Code of Conduct. The ASHK has issued guidance notes reflecting local experience and market conditions. The OCI has a range of supervisory powers to allow the effective resolution of problem insurance companies. It is funded through the government budgetary process, but to date does not appear to have had problems in generating required levels of financial support when needed.

### **Main findings**

151. The Insurance Authority (IA) obtains its authority under the Insurance Companies Ordinance (ICO) which sets out the objectives and powers of the IA. The IA has a range of powers under the ICO to carry out supervisory responsibilities covering all the key supervisory areas. The IA relies on the OCI staff for licensing, inspections, and enforcement. The OCI staff is held in reasonably high regard by the insurance industry.

### ***Organization of an insurance supervisor (CP 1)***

152. The OCI is a government department subject to the government's budgetary processes and administrative procedures. In practice, at present, the OCI has independence in action and the fact of government ownership is not seen as an impediment to the

effectiveness of insurance supervision. However, taking account of emerging international good practice and the potential for a rise in insurance-related risks, greater clarity in OCI's role, its operational independence, and a transparent accountability structure would enhance the effectiveness of insurance supervision in HKSAR.

***Licensing and changes in control (CPs 2–3)***

153. The OCI has adopted a broad range of criteria for assessing applications for authorization to carry on business. These include a review of premises, application of the fit and proper test and a review of the business plan of the company. The same basic criteria are used for an application to approve a change in control of the company.

***Corporate governance and internal controls (CPs 4–5)***

154. A broad Guidance Note on Corporate Governance has been issued that takes full effect in September 2003. Companies are currently going through a transition period to implement the new requirements.

***Prudential rules (CPs 6–10)***

155. The HKSAR has adopted prudential rules that generally follow the U.K. approach in terms of solvency and capital standards, although the insurance products in the HKSAR market often follow the U.S. approach. The OCI has adopted the appointed actuary approach and has placed reliance on the work of the actuary for supervisory purposes. Financial reporting and the calculation of reserves and provisions are not always consistent across the industry.

***Market conduct (CP 11)***

156. Market conduct is supervised through three SROs who report each year to the OCI on the activities and disciplinary actions taken against their members. While every insurance sales intermediary must belong to one of these organizations, there are few rules, or accepted practices and standards regarding the manner in which intermediaries deal with their policy holders. To deal with this issue, the OCI has established continuous professional development requirements for all insurance agents and brokers, and has recently introduced rules controlling policy replacement activities. Over time, these changes will help strengthen market conduct in the HKSAR but will need to be enhanced on a continuous basis in order to complete observance with the essential criteria in the IAIS Core Principles.

***Monitoring, inspection, and sanctions (CPs 12–14)***

157. The OCI carries out on site inspections of all insurance companies in HKSAR, including detailed review of the work of appointed actuaries. It also has the power to inspect the SROs and the offices of agents and insurance brokers. Financial reporting requirements however, need some strengthening to ensure greater consistency and reporting reliability.

***Cross-border operations, supervisory coordination and cooperation, and confidentiality (CPs 15–17)***

158. The OCI has entered into memoranda of understandings with three foreign insurance regulatory authorities, and works closely with the MPFA. Further strengthening of cooperation and exchange of information is needed, going forward, with the HKMA and SFC.

Table 8. Recommended Actions to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
<b>Organization of an Insurance Supervisor</b>	
CP 1—The supervisory process would observe the IAIS ICP if the OCI had more independence from government and greater control of its human and financial resources.	Define more precisely the status, resources, staffing and accountability of the OCI, with independent funding arrangement for insurance supervision. Consider introducing an equitable assessment system so the industry funds the costs of insurance supervision.
<b>Corporate Governance and Internal Controls</b>	
CP 4—Corporate governance requirements for insurance companies would observe the IAIS CP if standards relating to insurance companies were implemented.	Ensure early implementation of the Guidance Note on Corporate Governance, accompanied with proper training and dissemination of the spirit underlying its provisions.
<b>Prudential Rules</b>	
CP 6—The IAIS ICP on Assets would be met if stronger requirements were in place on asset quality and asset/liability matching.	Regulations should be reviewed to ensure that long term assets matching long term liabilities are clearly identified, and can be secured if necessary.
CP 7—The ICP on Liabilities would be met and strengthened by placing stronger requirements on appointed actuaries.	The framework within which the appointed actuaries system operates should be strengthened; OCI should enhance its regulatory oversight on appointed actuaries; eventually all actuaries should be required to be members in good standing of the Actuarial Society of Hong Kong
CP 8—The ICP on Capital Adequacy should be strengthened	Set up capital requirements for Class G and H business.
CP 9—The ICP on derivative instruments should be strengthened	Insurance companies should be required to disclose the extent to which, and the purpose for which derivatives are used.
<b>Market Conduct</b>	
CP 11—The supervision of market conduct should be clearly assigned and a mechanism established so that this important aspect of the business is clearly and appropriately supervised in order to meet this IAIS ICP	The IA or other competent body should have the power and responsibility to supervise market conduct in the insurance market, and carry out active oversight of the insurance sector self-regulatory organizations.
<b>Monitoring, Inspection, and Sanctions</b>	
CP 12—Financial reporting would be strengthened by establishing greater consistency in the financial reporting requirements.	The financial reporting requirements should be considered for harmonization so that all life insurance companies file statutory reports on the same accounting and reporting basis. Companies should be required to file their audited annual financial reports in a period less than six months after the end of the year.

### **Authorities' response**

159. The authorities raised issues with respect to the Core Principles relating to Liabilities (CP 7), and Financial Reporting (CP 12). As regards Liabilities (CP 7), the OCI is of the opinion that the appointed actuary approach best meets their need to have judgment applied to the specific risks each company faces using prudential approaches and assumptions that reflect the nature of the business carried out by the company. The authorities are aware of events in other jurisdictions that use the appointed actuary approach which have demonstrated weakness in placing too much reliance on appointed actuaries without adequate supervisory controls. Regarding Financial Reporting (CP 12), the OCI is satisfied that they can obtain and do receive sufficient financial and other information on insurance companies to supervise the sector. While the financial information for branches of foreign life insurance companies can, only with approval, be filed using the accounting standards in the home jurisdiction in which the company is based, the OCI is of the view that this added flexibility does not hinder sound supervision. The supervisory authorities do accept that this practice does hamper comparisons of company financial results and preparation of industry wide statistics. They also accept that greater consistency in the information collected would strengthen their supervisory practices. As regards the level of supervisory control over market conduct, the OCI contended that the market forces continue to act as an effective approach to providing this coverage at reasonable premiums and it controls the adequacy of pricing through the reserving and solvency requirements. The OCI has taken steps to improve information sharing and disclosure in respect of this business. While this step will improve the situation for these statutory classes of insurance, more specific legislative authority to oversee market conduct would strengthen the insurance supervisory regime in HKSAR.

### **VIII. CPSS CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS**

160. The assessment of HKSAR's observance of the CPSS Core Principles for Systemically Important Payments Systems (CPSIPs), and associated oversight responsibilities, focuses on the HK\$ RTGS interbank payments system HK\$ (CHATS) the main wholesale payments system. The other wholesale system the U.S. Dollar Clearing System was not assessed as the authorities do not regard it is being of systemic importance. The HK\$ RTGS has close linkages to the securities settlement systems assessed by the mission<sup>11</sup> and is critical to the sound functioning of HKSAR financial markets.

#### **Institutional and market structure**

161. The legal framework in HKSAR is well established but dynamic and evolving to meet the challenges of new payments instruments. Generally, there are no impediments to the effective enforcement of the contractual rights that underpin aspects of payments systems in

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<sup>11</sup>See also the assessment of the CPSS-IOSCO Securities Settlement Systems.

HKSAR. The authorities are addressing an issue regarding finality of payments (see CP 1 below).

162. The HK\$ RTGS is the key system supporting the operations of the wholesale markets for money, foreign exchange and securities trading. Participants open accounts at the HKMA and are licensed banks (required to be members) and restricted licensed banks (they have to apply to join). Hong Kong Interbank Clearing Limited (HKICL) operates the RTGS system, most of the major retail payments systems other than credit cards, and the U.S. Dollar Clearing System. HKICL's key role in supporting retail and wholesale payments is recognized by assessing not just wholesale but all its operations, against CP 8. The HKMA and the Hong Kong Association of Banks (HKAB) control HKICL. The Board is made up of two representatives from HKMA and six from the banks and is chaired in rotation by The Hong Kong and Shanghai Banking Corporation, Standard Chartered Bank, or Bank of China (Hong Kong).

163. In the HKSAR, retail payments activity is concentrated at relatively few banks but in wholesale financial markets the concentration of business is less. The degree of competition contributes to efficient banking practices. Data on the payments system suggest that payments through the RTGS systems make up close to 85 percent of the value of gross non-cash payments exchanged between banks in HKSAR. The remaining 15 percent are spread across the various retail payments instruments but mostly credit cards and checks. Credit cards account for almost 20 percent of all retail payments (including cash), a slightly higher share than checks. There are initiatives to improve the efficiency of the check system and to support transactions between HKSAR and the Mainland. Payments activity between the Mainland and HKSAR is small and expected to remain so. Debit cards and automated clearinghouse facilities are a growing component of the retail payments system and there are innovative products available such as Octopus stored value cards. The cash to GDP ratio is around 9 percent in HKSAR, which is high by international standards. In part this reflects significant offshore use of Hong Kong dollars.

### **Main findings**

164. The assessment highlighted the need to amend the law to ensure payments finality in the HK\$ RTGS. Also, payments system oversight is effective but would be improved by clearer legislative backing for HKMA. This could extend the reach of HKMA to all retail payment systems, including credit cards. Giving the HKMA explicit legislative authority to oversee all aspects of the payments system would be consistent with what is an emerging international standard of best practice. Placing separate groups in HKMA in charge of stability of payments systems and their development is suggested.

### ***Legal foundation (CP 1)***

165. A most important issue for payments systems is legal support for settlement finality. In HKSAR there is a timing problem related to insolvency. Insolvency commences at the time of the passing of a winding-up resolution or the presentation of a winding-up petition to



the court. Unless courts notify the HKMA instantaneously about the insolvency and the participant is suspended from the RTGS system, the participant could transact in the RTGS system while insolvent. Transactions made when insolvent would be open to challenge and could be unwound. This is a serious vulnerability as large transactions can be made in a matter of seconds. HKMA plans for a new law to address this problem are strongly supported.

166. The HKMA exercises oversight over payments system design through a patchwork of arrangements. Emerging best practice internationally is for payments overseers to have legislated oversight powers and responsibilities. Clearly defined powers are particularly important for effective oversight where there is a divergence of public and private interests as is often the case where competition and efficiency issues arise.

***Understanding and management of risks (CPs 2–3)***

167. The rules and procedures of the HK\$ RTGS system could be a more effective tool for understanding risks if presented with overview and explanatory material. There is no indication of who to approach for copies of the rules or guidance on how the rules are updated. They are only available to participants or applicants for membership of the system. The HK\$ RTGS system has functioned successfully without encountering liquidity problems. The mechanisms for managing liquidity risks are effective.

***Settlement (CPs 4–6)***

168. The HK\$ RTGS settles on a real-time gross basis and CP V is not applicable. Once a payment passes the test for availability of funds settlement is completed almost instantaneously. The HK\$ RTGS system settles across the accounts of the HKMA which are virtually free of credit or liquidity risk and are a sound settlement asset.

***Security and operational reliability, and contingency arrangements (CP 7)***

169. The overall security control in the HK\$ RTGS system is well designed. There is a dedicated unit set up in HKICL to handle all security administration functions and well respected products are used to establish network security. External IT specialists have audited the system annually since 2000 and their reports are available to HKMA and the HKAB. Business continuity planning and the resources devoted to ensure operational reliability are very good. The security and operational reliability of the HK\$ RTGS and the retail payments cleared through HKICL appears high.

***Efficiency and practicality of the system (CP 8)***

170. When the HK\$ RTGS started in 1996 high value payments quickly and voluntarily migrated to the new system indicating that the system meets user requirements. Pricing in the HK\$ RTGS is on a cost recovery basis and prices are not much different from those in comparable systems elsewhere. As an international financial center HKSAR has strong incentives to ensure the efficiency of its system and the HKMA are considering

enhancements to the system. All the indications are that the system meets user requirements and at a reasonable cost in terms of required liquidity and transaction tariffs.

***Criteria for participation (CP 9)***

171. Membership of the HK\$ RTGS is limited to banks to ensure high prudential standards apply to members. Prudential standards could be maintained at the same time as opening the system to additional members by setting entry criteria based on financial standing to allow a broader range of institutions to join the system. In terms of the stability of the system the current restrictions are not a problem but stability sometimes involves trade offs with efficiency although with such a large banking sector the trade off is less sharp than in many other countries.

***Governance of the payment system (CP 10)***

172. HKMA and HKAB as co-owners have representation on the Board of HKICL and the sub-committee that considers policy and operational matters. The co-ownership structure may not ensure that the balance between public and commercial interests is always appropriate. The HKICL Board should be open to public scrutiny and it would be appropriate for good governance for HKICL to publish an annual report on its activities including the performance of the HK\$ RTGS.

***Central Bank Responsibilities in applying the CPs***

173. There is no single law that supports HKMA's oversight activities. While oversight of the HK\$ RTGS is effective because of the contractual relations that cover the holding of accounts with the HKMA the disclosure of HKMA's role and major policies is complicated by its ownership role in HKICL and the lack of clarity in the definition of its oversight powers.

174. In its oversight of the HK\$ RTGS the HKMA has influence as a co-owner of the system operator and influence from its position as an overseer from outside the system. There is potential for conflicts of interest in these two role and the recommendations suggests that HKMA could consider whether these could be separated within HKMA. HKMA has developed a framework of cooperation both with other domestic regulators and those overseas that allows regular exchanges of views and information and allows HKMA to keep abreast of developments elsewhere which may impact HKSAR.

Table 9. Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank's Responsibilities in Applying the CPs—HK\$ RTGS (CHATS)

Reference Principle	Recommended Action
<b>Legal foundation</b>	
CP 1	The authorities should as a matter of priority introduce protections in the law to ensure that payments finality in the systemically important payments systems is undoubted.
<b>Understanding and management of risks</b>	
CP 2	HKMA and HKAB should review the presentation of the rules of the HK\$ RTGS. Matters bearing on the management of liquidity risks should be available in one consolidated source document. HKICL should do more to explain its rules and the background to them in material provided to participants and to the public.
<b>Criteria for participation</b>	
CP 9	The authorities should consider broadening access to the RTGS system.
<b>Governance of the payment system</b>	
CP 10	HKICL should publish material on its activities and its governance structure.
<b>Central Bank Responsibilities in applying the CPs</b>	
<i>Responsibility A</i>	The authorities could consider modifications to the legal basis for HKMA oversight of payment systems.
<i>Responsibility B</i>	The authorities should consider separating the functions of payments policy development and operational and project management activities by introducing a new stability focused unit.

### Authorities' response

175. The authorities have indicated that with regard to CP 1, they are seeking to introduce protections in the law to ensure that payments finality in the systemically important HK\$ RTGS is undoubted. The proposed law is to be drafted to ensure that transactions in the HK\$ RTGS System (and other systems as appropriate) cannot be challenged, even if a participant makes transactions after a court declares the participant insolvent. It is expected that legislative approval may be secured by end-2003. As regards CP 2, the authorities are of the view that the rules and procedures are well understood by the system operators and they do not see a need for a review to improve their clarity and accessibility. As of February 10, 2003, HKICL has established a website and that website will contain the latest Clearing House rules and regulations for access by participants of the clearing system and about other clearing and settlement services. Finally, with respect to the assessment of CP 9, the authorities are of the view that there is no need for any changes to the access criteria. They argue that the system already has a large number of participants (all licensed banks are

required to participate) and participation is also open to restricted license banks; so far, only one restricted license bank has decided to participate.

#### **IX. CPSS-IOSCO RECOMMENDATIONS FOR SECURITIES SETTLEMENT SYSTEMS**

176. The assessment of observance by HKSAR of the CPSS-IOSCO Recommendations for Securities Settlement Systems focuses on the two existing systems: Central Money markets Unit (CMU) and Central Clearing and Settlement System (CCASS). These systems have close linkages to the payment systems assessed by the mission<sup>12</sup> and are critical to the sound functioning of HKSAR financial markets. The assessment follows the CPSS-IOSCO Assessment methodology for Recommendations for Securities Settlement Systems that was approved in October 2002. The assessment relied on answers to the key questions of the RSSS, self-assessments made by the authorities (HKMA for CMU and SFC for CCASS), the recent publication of the HKSAR Redbook and the official documents on the two systems. Several meetings took place with HKMA, SFC, HKEX, custodians banks and brokers.

#### **Securities settlement systems infrastructure**

177. The market infrastructure in HKSAR comprises all the necessary components to support an important and active financial center. Following the demutualization and the merger of the Stock and Futures exchanges, that took place in March 2000, Hong Kong Exchanges and Clearing Limited (HKEX) acts as a holding company for the Stock Exchange and the three Central Counterparties clearing houses for the cash market, the derivative market, and for options. The Central Clearing and Settlement System (CCASS) is mainly used for the clearing and settlement of Exchange trades, while the Central Money markets Unit (CMU) provides settlement facilities for over-the-counter (OTC) operations on Exchange Bill and Notes (EFBNs) and private debt securities.

178. The participants in the Exchange are almost exclusively brokers. The banks are allowed to participate directly in the Exchange but they do not generally use that facility as they prefer to use the services of the brokers for the execution of the orders in the market. Licensed banks are the institutions most heavily involved in the provision of payments and securities settlement services. Some large banks having an important custody activity, have internalized a part of their securities operations that are settled in their own system. A substantial part of the securities market is still based on physical securities. Nevertheless, efficient solutions have been implemented to make possible the immobilization of the certificates and their transfer by book-entry, in particular for the equities held by the most active participants in the financial market. Several reforms are either being implemented or under consideration. One of the most important objectives is to pave the way to the development of a scripless securities market in facilitating the immobilization of the securities.

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<sup>12</sup> See also the assessment of the CPSIPS.

179. The CMU system was originally developed to provide a clearing and settlement facility for Exchange Fund Bills and Notes, which are issued by HKMA acting as an agent of the Government (tender operations). CMU was extended in 1994 to private debt instruments. HKMA follows a proactive policy of development of links between CMU and other securities settlement systems and it fosters the settlements in major foreign currencies, the aim being to become a securities hub for Asia. All transactions in CMU are made in a book entry form, with the securities being either dematerialized or immobilized. There are two different modalities of settlement, the securities could be either settled intraday and on a real-time basis, or at the end of the day through a netting system.

180. The CCASS system is both a central counterparty (CCP) for Exchange trades, and a Central Securities Depository (CSD). Most of the operations cleared and settled in the system are equities listed in the Stock Exchange. To be processed in CCASS the securities have to be immobilized in electronic book-entry form. The matching of trades is automated in electronic trading system (AMS/3) that sends settlement instructions to CCASS for clearing and settlement. Most Exchange trades are netted and transferred to the central counterparty that guarantees the settlement of the operations. To control the risk corresponding to this guarantee, CCASS uses several mechanisms including margins that are called at least one time a day. A Guarantee Fund, made up of participants contributions, own funds and insurance, gives the CCP the financial back-up to fulfill its settlement obligations in the event of a default of several participants. The settlement of the transactions happens two or three days after the trade date, depending on the modalities of payment for the transfer of securities.

### **Main findings: CMU Central Money Markets Unit**

#### ***Legal risks (Recommendation 1)***

181. The legal framework in HKSAR to a large extent supports each aspect of custody, clearing and settlement of securities. In particular, the law recognizes the dematerialization of Exchange Fund Bill and Notes and the immobilization of the other types of securities. The law recognizes netting arrangements and securities lending. However, upon insolvency, the Bankruptcy Ordinance will prevail. All settlements made before the insolvency of a participant are final but any transactions entered into after the insolvency of a participant will be subject to insolvency law. New legislation is under preparation, which aims at extending the exemptions of insolvency law to all important clearing and settlement systems. If adopted, this project will contribute substantially in strengthening the legal framework of HKSAR in this area.

#### ***Pre-settlement and settlement risks (Recommendations 2–10)***

182. There is no central counterparty (CCP) for the over-the-counter (OTC) market and no evaluation has been made of the benefits and costs of such an infrastructure. The limited size of the market for Exchange Fund Bills and Notes and private debt could make the benefits of a central counterparty relatively limited. Nevertheless, in a number of markets CCPs are not

only used for organized market operations but also for OTC products. The benefits and costs of a CCP for OTC market should be considered in looking at possible synergies with the existing CCP for equities in CCASS. The transactions could be settled intraday and in real-time given the seamless interface with the RTGS system. Nevertheless, this possibility of settlement is almost exclusively used for the settlement of repos with HKMA that permits the banks to get the liquidity they need to settle their operations in the payment systems. Most of the securities transactions are settled at the end-of-day in a netting of both securities and payments. No mechanism is in place to cope with a possible default of a participant to satisfy its obligation to pay or to deliver the securities except the right for HKMA to revoke the unsettled transactions. To avoid revocation of transactions, and the corresponding liquidity risks, the system should be able to withstand the risk of default of the largest participant. The settlements of securities transactions in foreign currencies (in particular the U.S. dollar and the Euro), and in commercial bank money, need to be carefully assessed and mitigated.

***Governance and other risks (Recommendations 11-19)***

183. There is a robust technical and operational infrastructure. There is also a detailed contingency plan that covers the processing activities relating to clearing and data processing. Internal controls and procedures are subject to internal and external audits. There is no specific Board for CMU. Major policy issues are reviewed by the Exchange Fund Advisory Committee which is chaired by the Financial Secretary. Members of the Exchange Fund Advisory Committee are drawn from the banking industry and other professionals in HKSAR and are appointed by the Financial Secretary. For major changes to the rules and procedures, CMU consults participants through briefings and seminars. There is no specific requirement for participation other than to belong to one of the categories that can apply for participation in the system. Within the broad policy lines defined by the Exchange Fund Advisory Committee, HKMA operates the CMU system and regulates it. The oversight of HKMA is non-statute based and is derived from its responsibilities regarding the oversight of payment systems and general concern for the stability and efficiency of the financial system. The activities of the banks in the securities market fall into the area of responsibility of HKMA which is in charge of banking supervision, while securities firm are supervised by the SFC. A Memorandum of Understanding (MOU) between HKMA and SFC defines a general framework of cooperation between the two authorities.

Table 10. Recommended Actions to Improve Observance of CPSS-IOSCO  
Recommendations for Securities Settlement Systems  
CMU Central Money Markets Unit

Reference Principle	Recommended Actions
Legal risk (Recommendation 1)	The legislation should be amended in order to extend the exemptions to insolvency law to all important clearing and settlement systems.
Pre-settlement risk (Recommendation 4)	The benefits and costs of a CCP for the OTC market should be considered in looking at possible synergies with the existing CCP for equities in CCASS.
Settlement risk (Recommendations 8–10)	The end-of-day netting of securities and payments should be able to withstand the risk of default of the largest participant. The risks of settlements in foreign currencies and in commercial bank money should be more carefully assessed.
Other issues (Recommendations 19–19)	To make governance more transparent and to take more into account the wishes of the users, the creation of a CMU User Group should be envisaged. HKMA's role and cooperation with SFC in the oversight of the securities settlement system should be reinforced.

**Main findings: CCASS Central Clearing and Settlement System**

***Legal risks (Recommendation 1)***

184. The legal framework in which CCASS operates is robust. In particular CCASS which is recognized as a clearing house benefits from specific dispositions existing in HKSAR law in case of insolvency. The Securities and Futures (Clearing Houses) Ordinance modifies the operation of the laws of insolvency, where a participant in a clearing house becomes insolvent. This is to ensure settlement activities and risk management measures can be taken and are not challenged under normal insolvency principles.

***Pre settlement and settlement risks (Recommendations 2–10)***

185. The trades are executed in the Exchange through the electronic trading system AMS/3 and settlement instructions are sent automatically to CCASS for clearing and settlement. Most Exchange trades are netted under the Continuous Net Settlement (CNS) system and their settlement is guaranteed. The corresponding risk is controlled with several mechanisms including margins that are called at least one time a day. A Guarantee Fund, made up of participants contributions, own funds and insurance, gives the CCP the financial back-up to fulfill its settlement obligations in the event of a default of participants. The settlement of the operations in CCASS follows several modalities. For Exchange trades that are netted and whose the settlement is guaranteed the final settlement happens normally one day after the securities have been transferred into the account of the buyers where they are put on-hold

pending the payment. The participants cannot get immediately these securities except if they anticipate the settlement by making the payment the day the securities are transferred (T+2). The second modality of settlements mainly concerns non Exchange trades (for example transactions between brokers and custodians). The settlements are made in the bulk payment system, in most of the cases the securities being delivered to the buyers one day before the payment is made.

***Governance and other risks (Recommendations 11–19)***

186. There is a robust technical and operational infrastructure. Full sets of contingency plans for each of the systems as well as a market-wide contingency plan have been put in place. These contingency plans are being rehearsed on a yearly basis and updated regularly or when significant changes arise. Data is transmitted in real-time to the backup machine of the relevant system and the estimated lead-time for recovering the operations at the backup facility is two and half hours. Regular audits are conducted on the operations of CCASS. The responsibilities of the Securities and Futures Commission (SFC) regarding clearing and settlement systems are clearly defined. In particular the rules of the clearing houses have to be approved by the Commission. In addition, according to the new Securities and Futures Ordinance, the SFC has as an objective to reduce the systemic risks in the securities and futures industry. The activities of the banks in the securities market fall into the area of responsibilities of HKMA which is in charge of banking supervision, while securities firms are supervised by the SFC. Nevertheless, the cooperation with HKMA in the field of securities settlement systems should be reinforced.

Table 11. Recommended Actions to Improve Observance of CPSS-IOSCO  
Recommendations for Securities Settlement Systems  
CCASS Central Clearing and Settlement System

Reference Principle	Recommended Action
Legal risk	The legislation should be amended in order to extend the exemptions to insolvency law to all important clearing and settlement systems.
Settlement risk	The links between the securities settlement system and the payment system should be improved in order to achieve DVP for all types of transactions. The use of the bulk clearing system should be abandoned and the cash settlements should be made in the RTGS systems. The settlement agent should be preferably the central bank, or a limited purpose bank for which the risks should be carefully checked.
	Risk controls for all type of transactions should be considered in order to ensure the timely settlement in the event that the participant with the largest payment obligation is unable to settle.
Other issues	HKMA's role and cooperation with SFC in the oversight of the securities settlement system should be reinforced.



### **Authorities' response**

187. The authorities agree on the need to reinforce the legal framework in order to extend the exemptions to insolvency law to all important clearing and settlement systems. A draft Clearing and Settlement Systems Bill is under preparation which will help strengthen the legal framework. HKMA has indicated that it will undertake a cost benefit analysis on the possibility for CMU becoming a Central Counterparty (CCP). HKMA and SFC share the views that the consequences of a possible default of a participant in the settlement of netting positions in CMU or in CCASS is sufficiently mitigated by existing procedures, and does not justify a change in the organization. Nevertheless, the assessor remains of the view that to avoid the liquidity and market risks that could arise from the incapacity of a participant to settle at the end of the netting cycle, the two securities settlement systems should have mechanisms that ensure timely settlement even when the largest participant is unable to settle.

188. SFC has indicated that the risks due to the use of banks as settlement agents is mitigated by the fact that they are all licensed banks supervised by HKMA. However, as part of the SCEFI II project the SFC has been working with HKMA and HKEX, on an organizational arrangement that would allow CCASS to settle all its operations in the RTGS systems. HKMA has also indicated that it will give further thought to the possible creation of a CMU User Group. As regards its role as overseer of securities settlement systems, HKMA's oversight applies to CMU and to money settlements arising from CCASS but not to the securities transfers in that system. Nevertheless, in view of the draft Clearing and Settlement Systems Bill, HKMA may consider further modalities in collaboration with the SFC that will clarify further the respective responsibilities of the two regulators in this area.

189. CCASS has already achieved DVP for all Exchange trades through the CNS system. For other types of transactions, participants may opt for the real-time DVP (RDP) system that settles in the RTGS system and ensures DVP. However, RDP is not chosen by the majority of market participants for such settlements. SFC has indicated that the RDP mechanism could be improved after Hong Kong Securities Clearing Company (HKSCC) is given special access to the RTGS system.

190. The SFC believes that there is no credit exposure in CCASS except for Exchange transactions that are going through the CNS system and guaranteed by HKSCC as a CCP. The other types of transactions including non-Exchange trades and isolated trades do not go through the net settlement system and are settled on a trade-for-trade basis between counterparties; and therefore do not subject CCASS to any principal risk

### **X. IMF'S CODE OF GOOD PRACTICES ON TRANSPARENCY IN MONETARY AND FINANCIAL POLICIES**

191. The assessment of HKSAR's transparency practices in monetary and financial policies was carried out with reference to the IMF's MFP Transparency Code, keeping in view the implementation issues outlined in the Supporting Document to the MFP

Transparency Code. The assessment reflects HKSAR transparency practices as of December 2002.

192. Under the Basic Law, the HKSAR's government shall, on its own, formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with law. The Chief Executive is the head of the HKSAR government and presides over the Executive Council, which assists the Chief Executive in policy-making. The Financial Secretary (FS), who is an ex-officio member of the Executive Council, is responsible for assisting the Chief Executive in supervising relevant policy bureaus, including the Financial Services Branch of the Financial Services and the Treasury Bureau, and in ensuring harmonization in policy formulation and implementation in the financial, economic and employment areas. The Chief Executive and the Financial Secretary are assisted in the discharge of their functions by the Financial Services Branch of the Financial Services and the Treasury Bureau on the one hand, and the principal regulatory and supervisory agencies/public servants on the other.

193. The principal regulatory and supervisory agencies/public servants in HKSAR responsible for the implementation of monetary and financial policies are: (1) the Monetary Authority (MA) assisted by his office known as the Hong Kong Monetary Authority (HKMA)—monetary policy implementation, banking supervision, payment systems oversight, and supervision of the exempt securities dealers (i.e., deposit-taking institutions operating in the capital markets); (2) the Securities and Futures Commission (SFC)—securities' markets regulation with the exception of the activities of exempt securities dealers; (3) the Insurance Authority (IA) assisted by his office known as the Office of the Commissioner of Insurance (OCI)—insurance regulation; (4) the Mandatory Provident Fund Schemes Authority (MPFA)—pension system oversight.

### **Transparency of monetary policy: main findings**

#### ***Clarity of roles, responsibilities and objectives of central banks for monetary policy***

194. The monetary policy objective of HKSAR is to maintain currency stability defined in terms of a stable external value of the Hong Kong dollar at a stable exchange rate between the Hong Kong dollar and U.S. dollar under the Linked Exchange Rate System. However, the monetary policy objective is not explicitly specified in the legislation. It is only implicitly derived from the purposes of the Exchange Fund, (which holds HKSAR foreign reserves) under the Exchange Fund Ordinance. According to the Ordinance, the Exchange Fund shall be used for such purposes as the Financial Secretary thinks fit, affecting, either directly or indirectly the exchange value of the currency. In addition it may be used for maintaining the stability and the integrity of the monetary and financial systems of HKSAR. The Financial Secretary's control of the Exchange Fund shall be exercised in consultation with the Exchange Fund Advisory Committee (EFAC).

195. The Financial Secretary appoints the Monetary Authority to whom he may delegate his powers and duties with respect to the Exchange Fund. HKMA, whose chief executive is

the Monetary Authority, is the institution de facto responsible for the implementation of monetary policy. Although it is not specified in the legislation, in practice EFAC acts as a management board of the HKMA. There is no explicit legal document establishing that the Financial Secretary has indeed delegated his powers to HKMA or the Monetary Authority, defining the terms of the delegation, and the responsibilities to be fulfilled. While the Monetary Authority is an individual in law and is considered to be a “corporation sole”, HKMA lacks a statute. According to the legislation the Financial Secretary can override the Monetary Authority, but there is no mandate to disclose in case the Financial Secretary overrides HKMA. The term of appointment and grounds for dismissal of the Monetary Authority and the members of EFAC are not disclosed in the legislation.

196. Monetary and fiscal operations are governed by their respective ordinances and conducted independently of each other. Under the Linked Exchange System there is little scope for discretionary money creation. The government places the fiscal reserves (from past accumulated fiscal surpluses) with the Exchange Fund. HKMA meets withdrawals by the Treasury to fund shortfalls in cashflow, either borrowing on the money market at market rates or drawing down the foreign reserves. Unlike government bureaus, HKMA does not publicly disclose its procurement rules.

#### ***Open process for formulating and reporting monetary policy decisions***

197. HKMA conducts monetary policy in a transparent way. Monetary policy is rather passive under the Linked Exchange Rate system. Exchange rate stability is maintained mainly through the automatic adjustment of interest rates. HKMA only provides liquidity to market participants under its intraday (free of charge), and overnight (based on a pre-specified formula publicly disclosed) facilities. For systemic purposes, solvent banks may obtain Lender of Last Resort support (LOLR) on a collateralized basis, but this facility has not yet been used. Daily information on the operations of HKMA through its overnight facility is posted on the HKMA’s website. Reporting on the achievement of monetary stability goals is mainly conducted through briefings by the Chief Executive of HKMA to the Legislative Council and through HKMA publications.

#### ***Public availability of information on monetary policy***

198. HKSAR has subscribed to the IMF Special Data Dissemination Standard (SDDS). The presentation and releases of HKMA macroeconomic data meets the SDDS specifications for the coverage, periodicity, and timeliness of the data and for dissemination of advance release calendars. The financial statements of the Exchange Fund are disclosed on a timely and pre-announced schedule. HKMA’s market transactions are disclosed on a real time basis. HKMA maintains a public information system that includes a publications program comprising the annual reports, quarterly and monthly bulletins, and other technical publications. The full program of publications is available on HKMA’s website.

***Accountability and assurance of integrity by the Central Bank***

199. HKMA acts as a manager of the Exchange Fund, and it does not have any assets or liabilities of its own. HKMA publicly discloses audited financial statements of the Exchange Fund. The auditor's report (including any qualification) constitutes an annex to the annual report, published four months after the end of the financial year. External audits of the Exchange Fund accounts are carried out by are audited by the Government Auditor who reports directly to the Chief Executive of the HKSAR. The internal audit division of HKMA is responsible for ensuring the integrity of operations. The IAD reports to the management of HKMA and to the EFAC-Audit subcommittee. HKMA staff is subject to a code of conduct rules, but there is no code of conduct for the members of EFAC.

Table 12. Recommended Actions to Improve Observance of IMF's MFP Transparency Code Practices—Monetary Policy

Reference Practice	Recommended Action
<b>I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy</b>	
1.1 The ultimate objective(s) and institutional framework of monetary policy should be clearly defined in relevant legislation or regulation, including, where appropriate, a central bank law.	<p>The legal foundation of HKMA should be clarified.</p> <p>The operational autonomy of the HKMA for the implementation of monetary policy should be explicitly recognized in a formal document. Such document, should define: (1) the ultimate objective of monetary policy; (2) the nature and the extent of the powers delegated to the Monetary Authority; and (3) the responsibilities that the Monetary Authority shall fulfill given the delegated powers and the ultimate objective of monetary policy. The document should be issued by the authority with the necessary legal power to: (1) specify the monetary policy objectives, and (2) delegate his powers in regard to monetary policy. With respect to the powers delegated, the document should clearly state the power of the Monetary Authority to use monetary policy instruments in order to achieve his objective within the existing monetary policy regime. If the Financial Secretary is to override implementation of policy decisions of the Monetary Authority, the circumstances should be clearly specified, as well as the modalities for disclosure of such events. The formal document, should also define the role of HKMA, the relationship between HKMA and EFAC, and the functions to be performed by EFAC. The term of appointment and dismissal procedures for the Monetary Authority should be defined, as well as for the non ex-officio members of EFAC to the extent it performs functions other than its advisory role under the Exchange Fund Ordinance. The document should be publicly disclosed and explained, both by the issuing authority and the Monetary Authority.</p>

Reference Practice	Recommended Action
<b>IV. Accountability and Assurances of Integrity by the Central Bank</b>	
4.4 Standards for the conduct of personal financial affairs of officials and staff of the central bank and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.	Members of the EFAC should be subject to a Code of Conduct.

**Authorities' response**

200. The authorities noted that although the relevant legislation does not set out any criteria for appointment or dismissal of the Monetary Authority and the members of EFAC, the persons who are empowered to make the appointments are all required under common law to act reasonably and take all relevant factors into consideration. Otherwise their decisions may be subject to judicial review. Relevant factors to be taken into account regarding appointment would include fitness for the office and those regarding removal would include serious failure of duty and grave misconduct.

201. The authorities are considering a set of letters to be issued by relevant authorities to set out clearly the respective roles and powers of FS, SFST and the MA as appropriate. The intention is to publish these instruments when they are ready. This would help enhance the transparency and accountability of financial sector policies.

**Transparency of financial policies: Main findings**

*Clarity of roles, responsibilities and objectives of regulatory and supervisory agencies*

202. The roles, responsibilities, and objectives of the government of the HKSAR and of the principal regulatory and supervisory agencies/public servants in the areas of banking supervision, and securities and insurance regulation are specified in legislation. Agencies' responsibilities for payment systems oversight and its objectives are not explicitly defined in legislation. There is little public disclosure on the issues discussed by the Council of Financial Regulators, and on the agreed policy actions.

203. The clarity of the institutional framework of financial policies and their transparency are diminished by: (1) the fact that the Monetary Authority and the Insurance Authority are individuals in law, whereas the HKMA and the OCI do not exist as such in the law though they are respectively the public face of banking supervision and insurance regulation in HKSAR, which raises issues of transparency and institutional accountability; (2) the lack of checks and balances and disclosure requirement on the CE's power to issue binding directions in all areas of financial policies except payment systems oversight; (3) the lack of checks and balances on CE's power, in consultation with the Executive Council, to exempt, modify or vary the provisions of the Insurance Companies Ordinance as they apply to any insurer, and on the FS's power to exempt any person from the provisions of the Banking Ordinance; (4) the fact that the Government Bureau (i.e., the Financial Services Branch of

the Financial Services and the Treasury Bureau) that assists the FS in the day-to-day exercise of his responsibility for formulation of financial policy is a different government department from the FS and consequently is not directly accountable for achieving the objectives conferred to the FS under the establishing legislation; (5) the complexity of the three-tiered regulatory framework of securities regulation; and (6) the piecemeal nature of the legislative basis for payments system oversight that creates potential for gaps.

### ***Open process for formulating and reporting of financial policies***

204. The regulatory framework for the conduct of financial sector policies is defined in ordinances and regulations, which are approved by the Legislative Council, and guidelines issued directly by the principal supervisory and regulatory agencies. All ordinances, regulations, and legislative amendments are published in the Hong Kong Government Gazette before commencement and are accessible online via the Bilingual Laws Information System. Guidelines issued by the principal supervisory and regulatory agencies are posted on their websites and sent to market participants. Industry organizations are regularly consulted before substantive changes in the regulatory framework are introduced. Further efforts by the OCI are called for to raise public awareness of the operating procedures governing its conduct of financial policies. Multilateral MOUs govern the cooperation and information-sharing between different domestic regulatory agencies, and between them and their international peers. The scope of all international MOUs in the areas of banking supervision and insurance regulation, however, remain outside the public domain. Because there is no single law giving HKMA payment oversight powers, in practice, it has developed a number of different methods for influencing developments in the payments system. Also because it often relies on contractual agreements, disclosure tends to be a low priority.

### ***Public availability of information on financial policies***

205. All principal supervisory and regulatory agencies in HKSAR adhere to high standards of disclosure and have adopted a proactive approach toward disseminating information on their policies. The HKMA, SFC, and OCI maintain comprehensive bilingual websites, which are regularly updated ([www.info.gov.hk/hkma/eng/](http://www.info.gov.hk/hkma/eng/), [www.hksfc.org.hk/eng/html/index.html](http://www.hksfc.org.hk/eng/html/index.html), and [www.info.gov.hk/oci/](http://www.info.gov.hk/oci/) respectively). All agencies publish periodic publications in a timely manner that cover their activities, main developments in the supervised sectors, and provide aggregate industry data. All periodic publications, except the OCI Annual Report, are freely available online. Senior officials from the HKMA, SFC, and OCI appear regularly before the Panel on Financial Affairs of the Legislative Council. The briefing materials are publicly released at the LEGCO's website ([www.legco.gov.hk/english/index.htm](http://www.legco.gov.hk/english/index.htm)). They also give speeches to the media and at public or industry events.

### ***Accountability and assurance of integrity by financial agencies***

206. The principal regulatory and supervisory agencies are accountable to the Chief Executive. In addition to the briefings to the Legislative Council, the HKMA and the SFC are under statutory obligation to prepare annual reports on their activities, including audited

statement of accounts, and submit them to the Financial Secretary, who places them before the legislature. The OCI is a government department and as such is subject to the general clauses of accountability of government officials. The specific modalities of the latter as they apply to the OCI, however, are not disclosed in the OCI's annual report, which also does not provide data on its budget allocation. All principal regulatory and supervisory agencies have well-established internal governance procedures to ensure integrity of operations and have developed internal arrangements for the conduct of personal financial affairs and prevention of exploitation of conflicts of interest by agencies' officials and staff although the quality of disclosure varies across agencies.

Table 13. Recommended Actions to Improve Observance of IMF's MFP Transparency Code Practices—Financial Policies

Reference Practice	Recommended Action
<b>V. Clarity of roles, responsibilities and objectives of banking supervisory agencies</b>	
5.1 The broad objective(s) and institutional framework of financial agencies should be clearly defined, preferably in relevant legislation or regulation.	<p>The legal foundations of the HKMA and the OCI should be clarified.</p> <p>The objectives of payment systems oversight and the delegation of FS's responsibilities in the area of payment systems oversight to the MA should be formally defined in a public document.</p> <p>To improve the transparency of the institutional framework for formulation of financial policies, the HKSAR government should issue a public statement outlining the circumstances under which the reserve power of the CE to direct financial regulators will be exercised. Full observance of practice 5.1 would require subjecting of the CE's power to direct to a publication requirement.</p> <p>Checks and balances on CE's power, in consultation with the Executive Council, to exempt, modify or vary the provisions of the Insurance Companies Ordinance as they apply to any insurer, and on the FS's power to exempt any person from the provisions of the Banking Ordinance should be introduced. There should be further clarification of the relationship and responsibilities regarding financial services of the FS and the Secretary for Financial Services and the Treasury, who heads the Financial Services and the Treasury Bureau.</p>
5.1.4 Where applicable, the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies should be publicly disclosed.	The procedures for appointment, terms of office, and grounds for dismissal of the Monetary and Insurance Authorities, and the members of the EFAC should be publicly disclosed. The criteria for exercising the power of the Chief Executive to remove from office the SFC's chairman and members of the Board of Directors should be publicly disclosed.
5.2 The relationship between financial agencies should be publicly disclosed.	Given the importance of cross-sectoral cooperation, the HKSAR authorities should define more clearly and publish the responsibilities, functions, and activities of the Council of Financial Regulators and the Financial Stability Committee.
<b>VI. Open process for formulating and reporting of banking supervisory policies</b>	

Reference Practice	Recommended Action
6.1.1 The regulatory framework and operating procedures governing the conduct of financial policies should be publicly disclosed and explained.	The operating procedures governing the conduct of financial policies in the areas of payment system oversight and insurance regulation should be explained to the public.
6.1.5 Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed.	The HKMA and OCI should establish permanent web pages on their websites with links to all signed MOUs with domestic financial agencies, similar to that on the SFC's website ( <a href="http://www.hksfc.org.hk/eng/miscellaneous/html/local-org.htm">www.hksfc.org.hk/eng/miscellaneous/html/local-org.htm</a> ). The existence and general scope of the MOUs signed with foreign supervisors should be publicly disclosed and the HKMA and the OCI should post on their websites a list of these memoranda, similar to that on the SFC's website ( <a href="http://www.hksfc.org/eng/miscellaneous/html/cross-border.htm">www.hksfc.org/eng/miscellaneous/html/cross-border.htm</a> ).

**Authorities' response**

207. The authorities indicated that the reserve power vested in CE over the financial regulators is necessary to reflect the government's responsibility to formulate monetary and financial policies and regulate and supervise financial markets as enshrined in the Basic Law. Such power would only be used as a tool of last resort to implement specific remedial measures in the most critical and extreme circumstances. Despite CE's reserve powers under the relevant financial services legislation, our constitutional and political convention is such that these powers have never been exercised. This convention of restraint is so deeply embedded that any arbitrary attempt to abuse the power would be politically untenable as it would not be accepted by the stakeholders. Moreover, when exercising such power, the CE has to be satisfied that the direction must be in the public interest and consistent with the objectives and functions of the regulators. The CE must act within the confines of the Basic Law and comply with any relevant international obligations on the HKSAR. Given these qualifications, the authorities felt that it would not be appropriate to restrict the CE's reserve power further.

208. The authorities noted that although the relevant legislation does not set out any criteria for appointment or dismissal of the regulators, the persons who are empowered to make the appointment are all required under common law to act reasonably and take all relevant factors into consideration. Otherwise their decisions may be subject to judicial review. Relevant factors to be taken into account regarding appointment would include fitness for the office and those regarding removal would include serious failure of duty and grave misconduct.

209. The authorities are considering a set of letters to be issued by relevant authorities to set out clearly the respective roles and powers of FS, SFST and the MA as appropriate. The intention is to publish these instruments when they are ready. This would help enhance the transparency and accountability of financial sector policies



## **XI. OECD PRINCIPLES OF CORPORATE GOVERNANCE**

### **Information and methodology used for the assessment**

210. The assessment of HKSAR's corporate governance practices, benchmarks its observance against the OECD Principles of Corporate Governance. The evaluation is based on an assessment template developed by the World Bank. The diagnostic carries considerable synergies with the assessments of the IOSCO Principles and the legal and accounting/auditing framework.<sup>13</sup> The assessment is based on the laws, regulations and supervisory practices at the time of the assessment, i.e., as of October 2002.

### **Institutional background**

211. Since the Asian crisis of 1997-98, the HKSAR has demonstrated its commitment to improving corporate governance. Substantial progress has been made to strengthen laws and practices and a number of consultation papers and reforms have been initiated. The new Securities and Futures Ordinance (SFO) contains measures to enhance corporate governance and the protection of shareholders; the ordinance is scheduled to come into effect in April 2003. The pending Companies Ordinance Amendments' Bill (CO) introduced into the Legislative Committee (LegCo) in January 2002 also seeks to enhance shareholders' rights and clarify directors' duties.

212. While the corporate governance shortcomings have been studied in depth and a number of reforms have been made, a string of corporate scandals serve as a reminder that problems persist. These incidents highlight the entanglement between public and private interests of some majority shareholders. Sometimes, issuers take advantage of regulatory arbitrage. Forceful action is necessary to reassure investors that the corporate governance framework provides enough checks and balances to ensure that corporate decisions are beneficial to all shareholders, rather than just the majority shareholders.

213. Regulation of the capital markets with respect to issuers rests on three-tiers: the government which sets policy; the Securities and Futures Commission (SFC) which mainly regulates the operations of intermediaries and the stock exchange;<sup>14</sup> and the Stock Exchange of Hong Kong (SEHK) which supervises listed companies through the listing rules. Where compliance is weak, enforcement of law and regulation is not always perceived to be forceful enough. The enforcement powers under the listing rules available to SEHK arise out of the contractual obligation between the SEHK and the issuer, and violations cannot be pursued in a court of law. Furthermore, there is an inherent conflict of interest for a de-mutualized stock

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<sup>13</sup> See Part I of the FSSA, and the summary assessment of the IOSCO Principles.

<sup>14</sup> The SFC directly regulates listed companies with respect to insider dealing, disclosure of interests in securities and protection of investors, as well as through the administration of the Takeovers Code.

exchange to retain its front-line regulatory function for listed firms. Various options to manage this conflict of interest and to re-evaluate the merits of the three tier regulatory system in general are being studied by a government appointed high-level review panel.

214. Most corporations in the HKSAR are controlled by families. Almost 90 percent of listed companies have one shareholder or one family group of shareholders owning 25 percent or more of the issued capital.<sup>15</sup> According to a study investigating ultimate control patterns in nine East Asian countries, fifteen of the largest twenty companies in the HKSAR are under family control, and ten families control approximately one third of the corporate sector.<sup>16</sup>

## **Main findings**

### ***The rights of shareholders***

215. This section assesses the basic property rights of equity investors, as well as their right to influence the corporation and participate in fundamental corporate decisions, primarily through informed voting. Shareholders should weigh the costs and benefits of exercising these rights. The market for corporate control should be efficient and the rules and procedures disclosed and fair.

216. Under the existing system of share registration in HKSAR, it is normally the clearing house of the stock exchange that appears in the company's register of members as shareholder, unless the beneficial owner holds the physical share certificate and registers directly. Only registered shareholders are considered "members" of the company and only they enjoy the rights stipulated in the company's articles of association and the Companies Ordinance. The election of directors to the board is not explicitly stated as a shareholder right.

217. Voting is usually done on a show of hands and one shareholder has one vote rather than one vote per share, unless a poll is demanded. On a show of hands, the clearing house has only one vote to represent all its shares. This vote is cast according to the balance of voting instructions, since the vote cannot be split.

218. The controlling shareholder groups, by using pyramid structures, cross-shareholdings, and offshore vehicles, are able to obtain a degree of control disproportionate to their equity ownership. Minority shareholders should be able to expect that these structures are disclosed. While the Securities (Disclosure of Interests) Ordinance requests disclosure, ownership

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<sup>15</sup> Cally Jordan, *Consultancy Report on the Review of the Hong Kong Companies Ordinance* (Hong Kong SAR: Financial Services Bureau), 1997.

<sup>16</sup> Stijn Claessens, Simeon Djankov, and Harry H. P. Lang, "Who Controls Asian Corporations?" Policy Research Working Paper 2054 (Washington: World Bank), 1999.

interests may be held at various levels of the corporate chain directly or through subsidiaries. Each entity reports its respective interests, which can lead to the same interest being disclosed various times. This is why establishing exactly which of the various persons reporting ownership is the beneficial owner, can be unduly complex.

219. In general, the amount of takeover activity reported suggests that the market for corporate control functions quite efficiently and that the general compliance with the disclosure requirements is reasonable. However, there is a danger that companies will try to take advantage of “regulatory arbitrage” by treating e.g. a corporate transaction as a sale of major assets rather than a takeover, and thereby avoiding having to subject themselves to the stringent takeover requirements. While such transactions appear unfair to outside investors, they comply formally with the non-statutory rules of the stock exchange.

220. Retail, as well as institutional investors use “exit” rather than “voice” to influence management. Asset managers owned by banks that maintain credit and advisory relationships with the companies they invest in, may face a conflict of interest when exercising their right to vote. As a result, institutional investors do not typically attend shareholder meetings and do not play an active role in corporate governance. Pension funds do not consider it their duty to intervene in companies by voting or otherwise, even where there is a reasonable expectation that doing so might raise the value of their investments.

#### *The equitable treatment of shareholders*

221. This section examines the confidence investors can have that the capital they provide will be protected from misuse or misappropriation by insiders. Given the strong rule of law in the HKSAR, investors can obtain redress for the violation of their rights, but the high cost of litigation makes the use of the judiciary system against management, board members or controlling shareholders unattractive for minority shareholders. There is no statutory derivative action, which would allow shareholders to sue on behalf of the company, nor do class action suits and contingency fees exist.

222. Concentrated ownership and complex ownership patterns of the HKSAR include structures where controlling shareholders own listed and private companies and where the relationship between the different companies is not transparent to the outsider. Given that controlling shareholders may have opportunities to engage in activities that advance their own interests at the expense of minority shareholders, including asset stripping and misuse or misappropriation of the capital provided by minority shareholders, it is important that such relationships be closely monitored and that strict rules apply as to how transactions between related parties are authorized. While applicable accounting standards and listing rules impose strict disclosure requirements on connected party transactions, a number of recent corporate scandals suggest that misuse of corporate assets and abuse in connected transactions remain a problem in the HKSAR.

### ***The role of stakeholders in corporate governance***

223. The formal rights of stakeholders, including employees, creditors, suppliers and the community, arise from sources such as labor law, environmental law, contract law or bankruptcy law. Stakeholders' interests are well respected and the legal framework and process are transparent and provide adequate legal protection for stakeholders. However, the legal aspects of stakeholder rights tend to take second place to implicit cultural obligations to resolve disputes quietly and informally.

### ***Disclosure and transparency***

224. While some gaps with regards to the quality of information of the annual and semi-annual reports can be observed, the reporting requirements are fairly complete. Compliance is monitored by the SEHK and adherence by listed companies is reported to be satisfactory. The range of sanctions available under the listing rules for non-compliance with reporting requirements is too limited. However, under the new SFO, the SFC will become the statutory regulator of disclosure by listed companies (dual filing). Companies will be required to file a copy of disclosure materials with the SFC. This will enable the SFC to employ its statutory powers of investigation where false and misleading information is filed with the SFC under the Listing Rules disclosure requirements.

225. Public perception of a lack of independence in the disciplinary process plus resource constraints raise questions about the effectiveness of the disciplinary arrangements for auditors. The Hong Kong Society of Accountants (HKSA) is not formally accountable to any public body, despite the fact that the Financial Secretary and the head of the accounting office have seats on the Board.

### ***The responsibilities of the Board***

226. While this section encompasses both legal and behavioral norms, the wide discretion granted to directors means that behavioral norms play a particularly significant role in guiding directors. For corporate governance reforms to take hold, a change in attitudes and practices at the company level is necessary. This is particularly important for family controlled firms which represent the prevailing corporate model in the HKSAR.

227. In the HKSAR as in other jurisdictions, even so-called "independent directors" are frequently chosen on the basis of loyalty and long-term personal relationships rather than technical skills and unbiased views. The mandate for independent directors means little without an effective definition of "independence," which should include both independence from management and controlling shareholders and possibly other relationships, such as representatives of companies that have significant dealings with the company. Board committees are especially important if they are composed largely of independent directors, and focus on areas of potential conflict of interests, such as audit and finance, risk policy, nomination and compensation.

Table 14. Recommended Actions to Improve Observance of the OECD Principles of Corporate Governance

Reference Principle	Recommended Action
<b>Rights of Shareholders</b>	<ul style="list-style-type: none"> <li>• Introduce a scripless market, so that share registration and ownership rights can be linked more easily.</li> <li>• Explicitly set out the shareholders' right to elect directors in the CO and listing rules.</li> <li>• Substitute voting on show of hands with mandatory polls.</li> <li>• Foster a pro-active approach to corporate governance by institutional investors, e.g., pension funds should publicly disclose their voting policy.</li> <li>• The regulatory arbitrage problem should be addressed in the context of the evaluation of the three-tiered regulatory system, which is currently being undertaken by a government appointed high-level review panel.</li> </ul>
<b>Equitable Treatment of Shareholders</b>	<ul style="list-style-type: none"> <li>• Encourage arbitration and other alternative dispute resolution mechanisms.</li> <li>• Introduce statutory derivative action against corporate wrongdoing.</li> <li>• Introduce a scripless market, which would facilitate beneficial shareholder registration in the company's share register and ease communications between companies, nominees and shareholders.</li> <li>• Tighten definition of connected transactions, taking into account associated companies. The code of best practice should address the approval process.</li> <li>• Introduce more stringent sanctions for minority shareholder expropriation.</li> </ul>
<b>Role of Stakeholders</b>	<ul style="list-style-type: none"> <li>• Educate companies and public about stakeholder rights through the code of best practice and awareness raising events.</li> <li>• Encourage companies to establish internal redress procedures for employee rights.</li> <li>• Encourage mediation and arbitration for other stakeholder disputes.</li> </ul>
<b>Disclosure and Transparency</b>	<ul style="list-style-type: none"> <li>• Introduce mandatory limited audit review of semi annual reports, avoiding "earnings management."</li> <li>• Follow international best practice on disclosure of individual compensation packages.</li> <li>• HKSA should propose a strict definition of auditor independence, focusing on the importance of personal relationships with owners/managers and the danger of auditor capture to the detriment of minority shareholders.</li> <li>• Annual reports should provide a breakdown of fees between audit and non-audit services</li> <li>• Improve the transparency of the audit disciplinary process, through focusing on compliance with the disclosure framework and disciplinary procedures for members of the profession.</li> </ul>

Reference Principle	Recommended Action
<b>Responsibilities of the Board</b>	<ul style="list-style-type: none"> <li>• Develop and disclose clear guidelines on the role, responsibilities, operation, structure, and qualification requirements of the board in the code of best practice.</li> <li>• Train directors in their fiduciary duties through the Hong Kong Institute of Directors and other organizations. Educate boards on stakeholder rights. Training should cover financial literacy, strategic planning, human resources, risk policies, budgets, accounting and governance issues.</li> <li>• “Independence” definition should include independence from management, controlling shareholders and other relationships.</li> <li>• The code of best practice should describe the roles, responsibilities, and structure and qualification requirements of different committees; and should recommend the establishment of specialized committees on areas of potential conflict of interest.</li> <li>• Ensure the presence (preferably a majority) of independent directors on key committees.</li> <li>• Companies should have nomination committees with formal and transparent procedures, so shareholders can easily nominate potential board candidates. Introduce a statutory requirement for the notice (which includes the candidates biographical details) to be circulated well in advance of the meeting. Reserve enough time for shareholders to lodge a nomination. The code of best practice should recommend that the entire board stand down for re-election every year.</li> <li>• Encourage cumulative voting, whereby minority shareholders can use all their votes to elect one director.</li> </ul>

**Authorities’ response**

228. The SFC provided useful factual clarifications and further comments relating to a number of OECD Principles of Corporate Governance, which have been reflected in the final assessment. Regarding the issue of auditor independence, SFC stated its reliance on HKSA to monitor the compliance of its members with the HKSA Statements of Professional Ethics.

**XII. ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM**

229. **The assessment of observance of the FATF 40 Recommendations for Anti-Money Laundering and the 8 Special Recommendations on Terrorist Financing was prepared by a team composed of staff of the International Monetary Fund and an expert not under the supervision of Fund staff who was selected from a roster of experts in the assessment of criminal law enforcement and non-prudentially regulated financial activities.** It provides a summary of the level of observance of the FATF 40+8 Recommendations and includes recommendations to strengthen observance and improve the AML/CFT framework.

**Information and methodology used in the assessment**

230. In preparing the detailed assessment, Fund staff reviewed the relevant AML/CFT laws, regulations, and other applicable rules, and the capacity and implementation of AML/CFT systems for prudentially regulated financial institutions. The independent anti-money laundering expert (IAE) reviewed the capacity and implementation of the AML/CFT

criminal law enforcement system and of AML/CFT systems for remittance agents and money changers (RAMCs).<sup>17</sup> The assessment used the comprehensive methodology approved by the Fund/Bank Boards and the FATF and is based, with few exceptions, on the information available when the mission was completed on January 23, 2003.

### **Main findings**

231. **HKSAR has a comprehensive legal and supervisory framework for AML/CFT.** The system was strengthened recently as a result of a number of amendments to the key AML/CFT laws that took effect on January 1, 2003. These amendments should help improve effectiveness in securing the confiscation of assets and the conviction of offenders in money laundering cases. In addition, HKSAR enacted the United Nations (Anti-Terrorism Measures) Ordinance (UNATMO) in July 2002, which would apply elements of United Nations resolutions to criminalization of FT and associated money laundering and enable the freezing and confiscating of terrorist assets; certain important parts of UNATMO need legislative approval of enabling regulations to become operational. AML/CFT laws are enforced primarily by the Hong Kong Police Force and the Hong Kong Customs and Excise Department, who together staff the Joint Financial Intelligence Unit (JFIU). The Hong Kong Narcotics Division plays an important role as coordinator of AML/CFT efforts. The Police and Customs work closely with the Department of Justice in investigating and prosecution of money laundering and terrorism finance cases. AML/CFT supervisory rules are enforced by the Hong Kong Monetary Authority for the banking sector, the Insurance Authority for the Insurance sector, and the Securities and Futures Commission for the securities sector.

232. The assessment finds that HKSAR complies well with the 28 assessable AML Recommendations other than with respect to the extension of AML rules to RAMC. There is, however, scope for further improvement and enhancement in some key areas, specifically as regards the informal nature and inadequate resources for the JFIU; the quality of suspicious transactions reports and the follow-up to those reports. Also, compliance is less complete with respect to the 7 assessable CFT special Recommendations, including as regards the ratification of the UN International Convention for the Suppression of the Financing of Terrorism and the full implementation of UN Security Council Resolutions 1269 and 1373 as regards freezing and confiscating of terrorist assets.

### ***Criminalization of ML and FT***

233. **HKSAR criminalizes ML in line with the Vienna and Palermo Conventions under the key AML/CFT Ordinances.**<sup>18</sup> These ordinances extend predicate offenses to money laundering to all serious offenses, including drug trafficking and FT offenses. They

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<sup>17</sup> Linda Samuel, Deputy Chief, Asset Forfeiture and Money Laundering Section, United States Department of Justice, served as the IAE. **Throughout this section the portions of the assessment attributable to the IAE are shown in *italics*.**

also provide for the freezing and seizing of the proceeds of crime or other criminal assets and require any person to disclose if he knows or suspects that any transaction relates to the proceeds of crime, or is intended to be used in a crime. Sanctions against money laundering include prison terms of up to 14 years and fines of up to HK\$5,000,000.

234. *Statistics reveal a disparity between the large number of investigations initiated and the relatively small number of resulting prosecutions and even smaller number of convictions, suggesting either that there are too many investigations or that there is some impediment to effectively prosecuting and securing convictions. While this data would have to be more critically analyzed before any conclusions on effectiveness can be reached, prosecutors have suggested that the issues with respect to establishing the intentional element of the offense (“having reasonable grounds to believe”) may play a role. Also, in general there is little investigation of or enforcement action taken with respect to AML/CFT requirements of corporate formation/secretarial services companies.*

#### ***Confiscation of Proceeds of Crime or Property used to Finance Terrorism***

235. **Changes to the DTROP Ordinance and OSCO that took effect on January 1, 2003, should assist the Government in prosecuting money laundering cases.** The most important measures are: no longer requiring advance notice to an absconded offender; requiring the court to fix a period of time in which a defendant is required to pay a confiscation judgment; permitting the court to enter a restraining order against assets upon the arrest (rather than charging) of a person; requiring the holder of property to produce documents and otherwise assist the government in assessing the value thereof; and creating an assumption under the DTROP to be consistent with OSCO that property held by a person convicted of drug money laundering within six years of the period of the violation is proceeds from drug money laundering.

236. **Courts are not currently empowered to order the forfeiture of property of terrorists or terrorist associates, or property that represents proceeds arising from terrorist acts.** The most important actions needed to clear the way for courts to approve the confiscation of terrorist assets are the legislative approval of regulations that would make effective the provisions of UNATMO providing for confiscation of assets without conviction (civil forfeiture) as provided for in section 13 of UNATMO; and the ability to freeze funds or other property of terrorists, terrorist financiers and terrorist organizations in accordance with the UN Convention for the Suppression of the Financing of Terrorism and UN Security Council resolutions on terrorism (section 6 of UNATMO).

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<sup>18</sup> The key AML/CFT laws are the Drug Trafficking (Recovery of Proceeds) Ordinance (DTROP), the Organized and Serious Crime Ordinance (OSCO) and the United Nations (Anti-Terrorism Measures) Ordinance (UNATMO).



### *Operations of the JFIU*

237. **The JFIU appears to suffer from its status as an informal arrangement between the Police and Customs Departments.** The somewhat ad hoc nature of the JFIU is reflected in the absence of a permanent staff with adequate safeguards against outside influence in its functions and decisions. The authorities are aware of this difficulty and have reported that the structure of the JFIU is currently being considered. *There are some indications that resources for law enforcement and the JFIU may not be fully adequate. In particular, there is no system for on-line electronic filing of STRs or any computer systems for analyzing STRs. The Police have reported that a request has been made for funding to conduct a feasibility study on developing a system to receive STRs electronically and to conduct analysis of the STRs on a more systematic basis. The staffing of the JFIU appears to be inadequate to examine all STRs or to conduct outreach to vulnerable professions that have not traditionally filed STRs. The authorities appear to be aware of these difficulties.*

### *International Cooperation*

238. **The Mutual Legal Assistance in Criminal Matters Ordinance of September 1997 and the Fugitive Offenders Ordinance of April 1997 provide the key legislative framework for assisting foreign jurisdictions in taking legal action against money laundering and terrorism financing.** HKSAR has signed 13 mutual legal assistance agreements and 13 surrender of fugitive offenders agreements with overseas jurisdictions, and has provided mutual legal assistance in a number of important anti-money laundering cases.

239. China has signed (i) the United Nations Convention Against Transnational Organized Crime and (ii) the International Convention for the Suppression of the Financing of Terrorism in December 2000 and November 2001, respectively, and consideration is being given to applying these Conventions to HKSAR once China ratifies them. A range of measures mandated by the International Convention for the Suppression of the Financing of Terrorism are already in place in HKSAR under UNATMO, as described above. However, HKSAR has not frozen or seized any terrorist assets. Also, the definition of a “terrorist act” in the UNATMO does not include acts intended to compel an international organization to do or to abstain from doing any act as provided by the International Convention for the Suppression of the Financing of Terrorism. The definition should be amended to include international organizations.

240. **HKSAR’s international cooperation regime, which provides for informal cooperation and the mutual recognition of foreign forfeiture judgments, is designed to advance international cases without necessitating a duplicate prosecution in HKSAR.** HKSAR has successfully given effect to forfeiture judgments rendered by courts in other countries. However, the “political offense” provision in the Fugitive Offenders Ordinance, Cap 503, provides a ground for refusing a request to extradite persons alleged to have been involved in terrorist financing activities. This provision should be changed to exclude terrorist financing.

*AML/CFT framework as applied to supervised financial institutions*

241. **HKSAR has effectively implemented a comprehensive framework for AML/CFT preventive measures for supervised financial institutions broadly consistent with applicable standards.** While a requirement to notify JFIU of transactions that are or can reasonably be believed to be the proceeds of crime or suspected to be the proceeds of terrorism finance is found in a statute (and applies to all persons, whether supervised or not), most of HKSAR's AML/CFT rules applicable to the supervised sector are found primarily in various guidelines issued by the three key financial regulatory bodies. The three sets of AML/CFT supervisory guidelines, which are in the process of being supplemented by additional guidelines primarily with respect to politically exposed persons and to terrorist financing, cover all the requirements of the FATF 28 + 7 assessable elements with respect to preventive measures.

242. **With respect to the customer identification framework for supervised sectors, the rules are adequate and are generally well implemented.** Circulars have been helpful, and include identification of terrorist names and accounts. There has been good cooperation among the three supervisors, the JFIU, the Police, and Customs. The supervisors and the JFIU have provided extensive training. The most important issue is identification of beneficial owners of shell companies, especially within the banking sector. Some domestic banks may use intermediaries who may not undertake adequate customer identification.

243. **The ongoing monitoring of accounts and transactions is generally effective in all three supervised sectors.** Suspicious transaction detecting should improve with the further development of management information systems as required by the supplements to the guidelines. While suspicious transaction reporting has increased, especially in the banking sector, there has not been a noted increase in quality, suggesting that there may be some "defensive" use of reporting. More sophisticated transactions (e.g., transactions by companies in the context of investment banking) could be more extensively addressed in the guidelines. Some compliance officers, especially in the domestic banks, are not as expert as they could be in recognizing suspicious transactions. As noted earlier, there is insufficient staffing at the JFIU for adequate examination of all STR reports (this would likely be the case even if the number of reports were to be reduced as the quality of reports increased). A lack of resources in the JFIU has made effective communication with regulated entities more difficult than it should be.

244. **The framework for internal controls, compliance, and audit is generally effective in all three supervised sectors.** All three sectors show active internal training programs supported by all three supervisors. New rules in the AML/CFT Supplements for specific internal AML/CFT assessments should be particularly helpful. Largely due to public awareness campaigns by the supervisory authorities, and to increased attention during examinations, since September 11, 2001, there has been a significant increase in management attention to AML/CFT internal controls and compliance standards in all three sectors, although perhaps most pronounced in the banking sector. However, better guidance is needed on manuals, including checklists, for AML/CFT self assessments. Screening of employees in

the domestic banks and smaller securities intermediaries below the level of senior staff could be improved.

**245. All three supervisory agencies have an established record of requesting information, and responding to requests for information, from each other and from foreign regulators, including on an informal basis.** However, some additional memorandums of understanding among the agencies need to be completed.

*AML/CFT framework as applied to remittance agents and money changers (RAMCs)*

**246. The remittance agent and money changer (RAMC) sectors are not subject to supervision.** However, the OSCO extends some but not all of the customer identification and record keeping requirements necessary to meet FATF standards to the RAMC sector. In addition, the duty to report suspicious transactions found in this ordinance and the DTROP and UNATMO applies to all persons, including the RAMCs. The ordinances also include a requirement for RAMCs to register. There are no laws with respect to maintaining internal controls or integrity standards.

**247. Many of the rules necessary to meet the FATF standards can be found in a booklet published by the JFIU entitled “A Guideline for RAMCs” (JFIU Booklet).** However, because the JFIU has no supervisory authority over RAMCs and therefore no authority to issue any guidance binding on that sector, the rules contained in the JFIU booklet are advisory only. If a criminal case is brought against a RAMC for violating the DTROP, OSCO, or UNATMO provisions, the courts will admit into evidence information on compliance with the rules found in the JFIU booklet. However, that does not make the rules binding. In addition to introducing additional rules needed to meet FATF standards (discussed below), a way needs to be found to make these rules binding on the RAMC sector.

*248. The Police are charged with implementing the provisions of the DTROP, OSCO, and UNATMO that apply to RAMCs. However, oversight over the AML/CFT duties of the RAMC sector has so far been inadequate to ensure effective levels of compliance. However, greater outreach and periodic examinations of this sector are planned for the near future.*

*249. With respect to customer identification, the ordinances do not require the RAMC sector to identify beneficial owners; the JFIU Booklet also does not include any related rules. There have been some reports that resident couriers acting on behalf of non-residents are being used to exchange large sums of foreign exchange, especially from the Mainland of China, into Hong Kong dollars for ease in opening bank accounts. For this reason, rules requiring the identification of beneficial owners may be of particular importance.*

*250. There have been very few STRs filed by RAMCs, suggesting inadequate compliance with reporting obligations. Very few investigations have been made in the RAMC sector and there was no systematic record keeping of such investigations.*

**251. While the ordinances do not require RAMCs to implement internal controls, compliance, and audit, the JFIU Booklet includes rules on designating a compliance officer**

and on screening employees that are similar to that provided in the Guidelines for the three supervised sectors. The ordinances do not require integrity standards for RAMCs; the JFIU Booklet also does not include any related rules.

Table 15. Recommended Actions to Improve Compliance with the FATF Recommendations

Reference FATF Recommendation	Recommended Action
<b>40 Recommendations for AML</b>	
General framework of the Recommendations (FATF 1–3)	Make rules found in JFIU Booklet mandatory.
Customer identification and record-keeping rules (FATF 10–13)	Extend requirements for customer identification provided in the Guidelines for the three supervised sectors to RAMCs. <i>Introduce broader and deeper system of inspections for RAMCs to ensure compliance.</i>
Increased diligence of financial institutions (FATF 14–19)	<i>Extend requirements for internal controls, compliance, and audit provided in the Guidelines for the three supervised sectors to RAMCs. Introduce broader and deeper system of inspections for RAMCs to ensure compliance.</i>
Other measures (FATF 22–25)	<i>Improve enforcement in RAMC sector.</i>
Implementation & role of regulatory and other administrative authorities (FATF 2–29)	Extend integrity standards provided in the Guidelines for the three supervised sectors to RAMCs.
<b>8 Special Recommendations on Terrorist Financing</b>	
I. Ratification and implementation of UN Instruments	The International Convention for the Suppression of the Financing of Terrorism to be ratified as soon as possible and applied in HKSAR. The definition of a “terrorist act” under the provisions of UNATMO should be revised to include acts intended to compel an international organization to do or to abstain from doing any act. HKSAR should fully implement UN Security Council Resolutions 1269 and 1373.
III. Freezing and confiscating terrorist assets	Section 13 of the UNATMO should be made operative to empower courts to order the civil forfeiture of property of terrorists or terrorist associates, or property that represents any proceeds arising from any terrorist act or consists of funds intended to be used, or having been used, to finance or otherwise assist the commission of a terrorist act.  Section 6 of the UNATMO should be made operative to allow the freezing of funds or other property of terrorists, terrorist financiers and terrorist organizations in accordance with the UN resolutions relating to the prevention and suppression of FT.
V. International Cooperation	The political offense provision in the Fugitive Offenders Ordinance, Cap 503, should be amended so as not to provide a ground for refusing a request to extradite persons alleged to have been involved in terrorist financing.
VI. Alternative remittance systems	Extend all rules provided in the Guidelines for the three supervised sectors to the RAMC sector.

Table 16. Other Recommended Actions

Reference	Recommended Action
Ratification and Implementation of UN Instruments	The UN Convention Against Transnational Organized Crime to be ratified as soon as possible and applied in HKSAR.
Confiscation of Proceeds of Crime or Property Used to Finance Terrorism	Consideration should be given to the adoption of laws that provide for the confiscation of the property of organizations that are found to be primarily criminal in nature.
Internal controls	Consider introducing an overall risk-based system for customer due diligence and suspicious transaction reporting (see, e.g., <i>Money Laundering: A Banker's Guide to Avoiding Problems</i> (Office of the Comptroller of the Currency, Washington, DC, December 2002). Expand guidance and training materials to focus more on sophisticated transactions. Increase the required skills and experience needed for compliance officers.
JFIU and STR Monitoring	<p><i>Consider whether the JFIU would benefit from a more formal structure. Increase resources for the JFIU, including staff, installing/improving data processing facilities/ databases and retrieval, and adding voice mail capabilities. The JFIU should enter into Memoranda of Understanding with other jurisdictions to facilitate the exchange of information.</i></p> <p><i>The JFIU should conduct additional outreach to vulnerable professions that have not traditionally filed STRs. Authorities should also consider pursuing criminal penalties in the appropriate case against a bank or other professionals failing to file STRs.</i></p> <p>In examinations, put greater emphasis on quality of monitoring and the resulting filing of STRs. Move the Business Records Office to an electronic data base.</p>
Law Enforcement and Prosecution Authorities, Powers and Duties	<p><i>Consideration should be given to enhance the penalty for the failure to file STRs.</i></p> <p><i>Consideration should be given to focus additional law enforcement efforts on the corporate formation/secretarial services companies sector.</i></p>
International Cooperation	<i>Consider lowering HKSAR's threshold for considering asset sharing requests.</i>

**Authorities' response**

252. HKSAR welcomed the assessment by the FSAP Team that HKSAR has a comprehensive legal and supervisory framework for AML/CFT and complies well with the 28 assessable AML Recommendations. HKSAR noted the Team's remarks that the AML/CFT legal and institutional framework for all financial institutions is effective, and that there is good cooperation among the supervisors, the JFIU, the Police and Customs.

253. HKSAR remains vigilant in enhancing its AML/CFT regime to keep in step with international standards. However, in the context of the current assessment exercise, it is the considered view that the assessments should not be made against parameters which exceed current international standards or where no international standard exists.

254. **Disparities between restrained and confiscated assets and the civil forfeiture system.** The difference between the restrained and confiscated assets under OSCO has to be interpreted in the context of the present conviction-based confiscation regime and the economic conditions which HKSAR experienced in the past five years. The disparity can be caused by a variety of reasons including the time between restraint and any conviction, non-prosecution, acquittal, devaluation of the assets and others. It would be normal to have a gap between the amounts of restrained and confiscated assets at any point of time. As for the application of civil forfeiture to confiscation of criminal proceeds, HKSAR will closely monitor the development of such systems in overseas jurisdictions.

255. **Establishment and resources of JFIU.** The JFIU has been in operation since 1989. Whilst it is not a statutory body, it is a formal establishment within the police and customs departments, with full accountability to the respective administrations. The current structure of the JFIU has been found to be very effective. There is already certain temporary redeployment of officers within the police and customs to meet with the increase in the workload of the JFIU. Further, the police are conducting a review of the manpower and structure of the money laundering investigation units with a view to re-engineering its services. In respect of the recommendation concerning voice mail, all telephones of the JFIU are manned during office hours while the JFIU Hotline is diverted to an answering machine with voice recording function after office hours. As for electronic filing of STRs, a computerized system to receive and process STRs submitted electronically is currently being developed.

256. **Remittance agents and money changers.** HKSAR has been taking proactive steps in regulating RAMCs through a registration system. Since 2000, HKSAR has introduced legislation requiring RAMCs to register their business with the authority and to take AML measures such as identification of customers and keeping of records. HKSAR will conduct a review of the AML requirements for RAMC sector in the light of the revised FATF 40 Recommendations.

257. As to the recommended actions above, the authorities have the following comments:

- On the **Ratification and implementation of UN Instruments**, the International Convention for the Suppression of the Financing of Terrorism will be applied to HKSAR when China ratifies the convention. That said, legislative proposals will be made to fully implement relevant articles concerning 'terrorist act compelling an international organization to do an act' and 'political offense'. Likewise, measures will be taken to implement the UN Convention against Transnational Organized Crime when it is ratified by China and applied to the HKSAR.

- **On Freezing and Confiscating Terrorist Assets**, HKSAR is in the process of introducing legislative proposals on protocols and rules to facilitate commencement of sections 6 and 13 of UNATMO on freezing and forfeiture.
- **On Internal Controls**, the Bank Guideline contains examples of suspicious indicators including, among others, money laundering activities involving the use of investment related transactions, offshore international activities, etc. Further guidance on more sophisticated transactions from international bodies would be considered.
- **On JFIU and STR Monitoring**, the JFIU has made extensive efforts in providing training to all sectors which are likely to report STRs. Work is done with the professional bodies in outreach programmes to ensure a high level of awareness of AML/CFT obligations. The JFIU has established an STR working group in 1998 with participation by law enforcement agencies, financial regulators, financial sector associations, professional bodies and government policy makers. This is a forum in which public and private sector representatives are updated on the latest money laundering trends. Another key objective of the working group is to improve the quality of the STRs. Likewise, the HKMA examiners review STR registers and records to ascertain the effectiveness of the STR identification systems during on-site visits.
- **On Law Enforcement and Prosecution Authorities, Powers and Duties**, there is at present no international standard on the control of corporate formation/secretarial services companies. Under the legislation of HKSAR, the offenses of money laundering and terrorist financing are applicable to any person. The obligation to report STRs is also extended to any person. In HKSAR, corporate formation/secretarial services companies generally consist of accountants and lawyers who are already subject to AML/CFT requirements. HKSAR conducts investigations on these services providers in line with its established enforcement policies.