Guideline 2.1

Our Ref. : CB/Bank/26

The Chief Executive
All Authorised Institutions

Dear Sir/Madam,

Supervisory Approach

Our responsibilities in supervising authorised institutions are to seek that institutions conduct their business prudently, conforming to the requirements of the Banking Ordinance. In discharging our responsibilities, we have hitherto relied principally on on-site examinations (supplemented by consideration of statistical information contained in regular banking returns).

2. As noted in my Annual Report for 1987, we have been reviewing the way we supervise and have concluded that new methods could be used to improve the effectiveness and efficiency of supervision. This letter describes a broader approach to our job.

The new approach

3. The broader approach emphasizes the continuous nature of supervision, early detection of problems, and the need for the efficiency. These aims will be achieved through :

(a) supplementing on-site examinations with other methods ;

(b) focussing examination efforts on potential or identified prudential concerns; and

(c) prioritizing the deployment of our limited supervisory resources.

This approach should also result in a more frequent dialogue with institutions' management, without - for most, if not all, institutions - imposing additional burdens on their resources; indeed, in many cases the burden should be less than at present.

4. The methods to supplement on-site examinations are:

(a) off-site reviews;

(b) prudential meetings.

Off-site reviews

5. Off-site reviews aim at understanding the operations of an institution, monitoring its financial position, detecting emerging problems or concerns to be explored in greater detail (through prudential meetings, examinations, or otherwise).

6. An off-site review involves analysing information provided by the institution through:

(a) statistical returns;

(b) internal management accounts and other management information;

(c) published financial information.

7. The statistical returns are in standard format applicable to all authorised institutions. We are in the process of revising some of these returns, in consultation with the Hong Kong Association of Banks and the Hong Kong Deposit-taking Companies Association. New returns will be used to replace existing ones as and when they are ready. (Institutions will be given adequate time to adapt their systems to new information requirements.)

8. Apart from the regular returns, we ~~will~~ need to call for supplementary information from time to time, including non-financial information such as institutions' internal policy statements on particular areas of operation. Institutions will be required to notify us of material changes to their established policies.

9. As regular supplementary inputs for review, we ~~will~~ also require institutions to provide us with internal management information (e.g., financial budgets, forecasts, bad and doubtful loan reports, profit and loss accounts). The purpose of looking at this information - which serves as the basis for management decision-taking - is to understand the development and prospects of the institution, and to enable us to discuss matters with the management drawing on the same set of information. It does <u>not</u> mean that we will take part in management decisions, which remain the prerogative of the management.

10. Internal management information will of course neither ~~be~~ in standard format nor ~~be~~ uniform in content; the information used by the management of an international bank which is part of a complex financial group differs significantly, in form and in substance, from that used by the management of a small, locally orientated institution. We have no intention of imposing additional reporting burdens on institutions. There is therefore no need to recast internal management information in a different form before passing it to us.

11. Off-site reviews will be undertaken regularly and routinely. We will therefore ask for relevant management information from institutions at such times.

Prudential meetings

12. We attach great importance to a regular dialogue with the senior management of authorised institutions. Under the broader approach, These - dialogues will be conducted through prudential meetings, to be held once or twice a year.

13. Prudential meetings aim at :

(a) understanding how the institution's management controls its operations, and views its business situation and prospects. We will usually wish to discuss the institution's business plan and strategies during these meetings;

(b) clarifying specific queries and discussing prudential concerns arising from off-site reviews or elsewhere;

(c) as a result of (a) and (b), giving a greater focus to on-site examinations.

14. It may often make sense for prudential meetings to be held in the institution's premises to enable us to talk to a broad range of management. Meetings will be held about twice a year for institutions for which we have the principal supervisory responsibilities. For branches of certain overseas banks, and their subsidiary, deposit-taking companies, we can often place substantial reliance on their home supervisory authorities. Meetings with the local management of these institutions will generally be held once a year. In addition, we may find it helpful to hold discussions with institutions overseas head offices, either through our staff calling on them or during their visits to Hong Kong.

15. Some institutions are part of a financial group. For them we *may* wish to hold prudential meetings with the group and with major subsidiaries separately, to enable us to understand their overall position.

On-site examinations

16. On-site examinations will remain an indispensable tool. However, with the introduction of off-site reviews and prudential meetings, detailed examinations will be conducted less frequently. In addition, selective examinations will be conducted if an off-site review or a prudential meeting indicates an area of concern, an emerging problem, or an aspect of the institution's operation that we need to understand in more depth. Certain areas can only be assessed reliably through on-site examinations : asset quality and

the operation of institutions' internal controls are two major examples. When an examination is conducted, it will focus on specific areas of business. The scope of an examination will be spelt out in a letter to management in advance.

Follow-Up action

17. A prudential meeting or an on-site examination will usually be followed by a letter from us to management listing any areas of supervisory comment, concern or need for action. For an institution incorporated overseas, or a subsidiary of an overseas bank, a copy of an examination report will be sent to its head office or parent bank, and to its home supervisory authority (where this is subject to adequate secrecy provisions; any information relating to the affairs of any individual customer of the institution will be deleted).

Working with auditors

18. We now work with institutions' auditors in a number of ways. The auditor is required to certify the correctness with which an institution's banking returns have been compiled, usually once a year. He is also required to state in his certificate whether or not he is–satisfied that there was nothing which adversely and materially affected the financial position of the institution during the reporting period. In supervising an institution, we ask to see the auditor's management letter, if any. We expect the auditor in his audit to look at any correspondence we have had with the institution. The Banking Ordinance provides for–tripartite meetings between the management, auditor, and us. A number of these meetings are held every year, usually at our initiative.

19. We have found these arrangements useful. We are now exploring ways to strengthen them, in consultation with the Hong Kong Society of Accountants, the Advisory Committees and the industry.

Implementation

20. Over the past few months, we have initiated the elements described in the preceding paragraphs with a number of institutions. We are encouraged by the results and by institutions' cooperation. We consider that it is now appropriate to adopt the approach for all authorised institutions. I hope that it will enable us to work towards maintaining a stable banking system in an effective and efficient way.

Yours faithfully,

(A.W. Nicolle)
Commissioner of Banking

c.c. Local representative offices