

FINANCIAL DISCLOSURE BY OVERSEAS INCORPORATED AUTHORIZED INSTITUTIONS

Introduction

1. This paper sets out the minimum standards recommended by the Hong Kong Monetary Authority (“HKMA”) for financial disclosure by overseas incorporated authorized institutions.

Background

2. Since 1994 the HKMA has, in conjunction with the banking industry, other financial regulators and the accounting profession, made significant efforts to improve the standard of financial disclosure by authorized institutions incorporated in Hong Kong. The results of this work are embodied in the “Best Practice Guide on Financial Disclosure by Authorized Institutions” (the “BPG”) which was first introduced in 1994. In each of the subsequent years, the BPG has been expanded to keep up with developments in other financial centres and as a result the standard of financial disclosure by locally incorporated institutions is now comparable with other major international financial centres. The increase in transparency of the operations of banks has also been widely acknowledged as a contributing factor to the continuing stability of the banking sector.

3. However, this level of transparency has not been extended to overseas incorporated institutions operating in Hong Kong. This stems from the fact that the requirement to prepare accounts under the Companies Ordinance only applies to locally incorporated companies. Therefore overseas incorporated institutions operating in branch form are not required to produce accounts for their local operations in the same way as their locally incorporated counterparts. The operating results and financial position of their Hong Kong operations are reported only to their head office with any financial information published subsequently only on an aggregate basis. This is generally the case even for institutions which have a substantial retail and commercial presence in Hong Kong. The lack of information concerning the operation of these institutions is at odds with the significant market share they hold in Hong Kong and represents a significant gap in transparency of the domestic banking sector as a whole. To illustrate their presence in the local market, as at the end of 1997, foreign banks accounted for 56% of total loans for use in Hong Kong and 28% of total customer deposits. This situation means that a substantial portion of the information about the local banking sector is missing and that market discipline is less effective in helping to govern risk taking by these banks. This also gives rise to issues regarding level playing field vis-à-vis their locally incorporated

competitors when they are all competing in the same market and for the same customers, that is, foreign banks have more information about their local competitors than vice versa regarding their local operations.

4. At the same time, it is well recognised that financial information at the branch level, which only refers to operations at a particular location, cannot contain all the relevant information for a proper assessment to be made on the financial position of the bank as a whole. Quite often, the operations of a local branch are supported by the head office through funding arrangements and other operational assistance. Therefore disclosure of financial information at only the branch level may not provide a fair view of the institution as a whole. However, this is considered to be an issue in determining the type of information that should be disclosed rather than a reason for deviating from the principle of transparency.

5. The HKMA is also aware that a similar conclusion is being drawn by the consultants undertaking the strategic review of the Hong Kong banking sector. This provides additional support for the HKMA's case to increase the level of disclosure by foreign banks in Hong Kong.

6. In view of the above, the HKMA expects institutions incorporated outside Hong Kong (except those which meet the exemption criteria in para. 15 below) to disclose on a half-yearly basis (i.e. for the first six months of each financial year and for the whole of the financial year at year end) selected financial information concerning their operations in Hong Kong. As mentioned above, the disclosure of financial information at the branch level may not result in a fair representation of the financial position of the institution as whole. Therefore, overseas incorporated authorized institutions should also disclose certain information concerning the financial strength of the institution as a whole on a consolidated basis in order to place the branch operations in Hong Kong into proper perspective. This would allow users of such information to better judge the financial strength of the institution both in the local context and in totality. Details of the disclosure requirements are set out below.

Key financial information to be disclosed

7. The disclosure items are set out in Annex 1 the Key Financial Information Disclosure Statement ("Disclosure Statement") which contains two main sections. The first section of the Disclosure Statement ("Branch Information") deals with financial information concerning the operations of the local branch. This includes key on- and off-balance sheet items drawn from the BPG, which aim to give an impression of the size and nature of an overseas incorporated institution's operation in Hong Kong and the quality of its assets. Therefore, the information disclosed in this section should cover the position of

the Hong Kong offices only. The BPG was used as a basis for determining the information to be disclosed by the branch as it would provide comparability between local and overseas incorporated institutions operating in Hong Kong. Profit and loss information has not been included because, in the majority of cases, institutions operating in branch form are often subject to specific funding and provisioning requirements determined by their head office. Such requirements differ between institutions and therefore any information disclosed in this respect may be difficult to compare. This portion will however be kept under review.

8. The second section of the Disclosure Statement (“Bank Information”) deals with disclosures concerning the financial strength of the institution as a whole on a consolidated basis and such information helps place the operations of the branch within the overall context of the whole institution. Such information would include capital and capital adequacy, total assets, profitability, etc. This type of information is generally accepted and used by the market participants as indicators of the financial strength of an institution.

9. It should be noted that the disclosure requirements in respect of branch information include a breakdown of overdue advances by the length of time overdue and the aggregate amount of rescheduled advances. For the latter, these refer to loans that have been restructured or renegotiated because of a deterioration in the financial position of the borrower or of the inability of the borrower to meet the original payment schedule. Disclosure of overdue and rescheduled loans will be optional for the first year.

10. Such information is already being collected by institutions in their reporting to the HKMA and thus should not represent a significant additional reporting burden. These proposals are in line with a specific recommendation of the IMF in connection with its 1997 Article IV consultation exercise in Hong Kong that more information should be provided about banks’ problem loans.

11. In line with the requirements for locally incorporated institutions, overseas incorporated institutions should also disclose specific information about the Year 2000 problem. This includes information on progress on Year 2000 compliance in the context of both the local branch and the institution as a whole. The type of information required is similar to that applicable to listed companies in Hong Kong.

Implementation issues

Effective date

12. The requirements will apply to relevant authorized institutions incorporated outside Hong Kong (see paragraph 15) in two parts :

- First part – in respect of their Disclosure Statements for financial or interim financial periods ending on or after 31 December 1998, all disclosure other than overdue loans and related information i.e. Annex 1, Section A, items II (vi) and (vii);
- Second part – disclosures on overdue loans and related information i.e. Annex 1, Section A, items II (vi) and (vii) will be optional for the first year. The HKMA intends that, after review of the initial round of disclosure, all relevant institutions should make these disclosures in the Disclosure Statements for financial periods ending on or after 31 December 1999.

Release, display and availability of Key Financial Information Disclosure Statement

13. In order to reduce the cost burden on institutions, it is not suggested that institutions should publish their Disclosure Statements in newspapers (although they may do so if they choose). Instead, these statements should be issued in the form of a press notice containing the relevant Disclosure Statement in both English and Chinese to newspapers circulating in Hong Kong within three months from the end of each financial period. A copy of the statement should also be displayed in a conspicuous position in the principal place of business of the institution in Hong Kong and in each local branch if applicable. The statement should also be made readily available to members of the public on request. Institutions should lodge a copy of the press notice with the HKMA one week prior to release. The HKMA will keep such notices in its public registry maintained under section 20 of the Banking Ordinance.

14. The HKMA is also proposing legislative changes to the Banking Ordinance early next year to remove the requirement for local banks to publish their annual accounts in the newspapers. If this is achieved, a similar requirement to the above would be introduced for local banks to ensure consistent treatment.

Exemptions

15. The recommendations apply to all overseas incorporated institutions whose Hong Kong offices currently have total assets of HK\$10 billion or more or total customer deposits of HK\$2 billion or more.

16. Consistent with existing practice, the HKMA will use the figures which institutions report on item 25 (Total assets less provisions) and item 6.4 (Total deposits from customers) of the Return of Assets and Liabilities of an Authorized Institution (Form MA(BS)I) to determine whether an institution meets the above size criteria. The average of the relevant figures reported in the twelve month period up to end-August will be adopted in order to avoid the effects of one-off fluctuations at the end of the period.

Audit and certification of disclosures

17. Institutions will not be required to have their Disclosure Statements audited. However, they should include a statement by the Chief Executive of the institution that the disclosure complies with the HKMA's recommendations and is not false or misleading. In cases of partial compliance, the statement of the Chief Executive should specify the areas of, and reasons for, non-compliance.

Compliance

18. The HKMA expects all overseas incorporated institutions other than those which meet the exemption criteria to comply with these recommendations. It will also consider whether the Banking Ordinance should be amended to include adequate disclosure of financial information as a criterion for authorization for all authorized institutions irrespective of whether they are incorporated in or outside Hong Kong.