

FINANCIAL DISCLOSURE BY LOCALLY INCORPORATED AUTHORIZED INSTITUTIONS 2002

Introduction

1. This paper invites comments on the proposed updates to the annual and interim financial disclosure standards for locally incorporated AIs for financial periods ending on or after 31 December 2002.
2. Since the implementation of the Basel New Capital Accord and the Hong Kong equivalent accounting standards of International Accounting Standards (IAS) 39 and 32 on financial instruments is likely to entail significant changes in the bank disclosure framework, the updates proposed this year are again primarily of a “de minimis” nature. In identifying possible updates, reference has been made to recent papers issued by the Basel Committee on Banking Supervision¹ and the Stock Exchange of Hong Kong² (SEHK), international accounting standards and other international best practices on financial disclosure. Similar proposals are made for overseas incorporated AIs, as appropriate.
3. For ease of reference, the proposed updates to the disclosure standards are shaded and in bold italics in the annexed packages, “Financial Disclosure by Locally Incorporated Authorized Institutions” (FD-1) and “Interim Financial Disclosure by Locally Incorporated Authorized Institutions” (FD-2).

Details of proposed updates

(i) Corporate governance (section 3.2 and para. 3.3.2 of FD-1)

4. The HKMA updated its guideline on “Corporate Governance of Locally Incorporated Authorized Institutions” in September 2001. All local AIs are required to comply with the guideline. It is considered that disclosure of compliance with the guideline and how the board of directors and its specialised committees discharge their duties (including the major areas or topics reviewed and discussed by the audit committee) would provide valuable information, in particular on board control of the risk management and internal control systems of an AI. Disclosure of these aspects is in line with the proposals by the SEHK for listed companies. It is considered appropriate to extend such disclosure to all AIs, listed or unlisted.

¹ These papers include “Best Practices for Credit Risk Disclosure”, “Public Disclosure of Trading and Derivatives Activities” and “Public Disclosures by Banks: Results of the 2000 Disclosure Survey”. They are available on the BIS website: <http://www.bis.org/bcbs/publ.htm>.

² The consultation paper “Proposed Amendments to the Listing Rules Relating to Corporate Governance Issues” issued by the Stock Exchange of Hong Kong is available on the website: <http://www.hkex.com.hk>.

(ii) Disclosures on derivatives and hedging (paras. 2.7.3, 2.7.4 and 3.3.3 of FD-1)

5. The survey included in the recent paper “Public Disclosures by Banks: Results of the 2000 Disclosure Survey” by the Basel Committee shows that about three quarters of international banks are disclosing their objectives for the use of derivatives and strategies for hedging risk in their public disclosure. The Basel Committee also recommends disclosure of the treatment of hedging relationships affecting the measurement of assets. In terms of qualitative disclosure, the current disclosure requirements only require a generic description of the principal accounting policies adopted in respect of off-balance sheet transactions. It is considered that enhanced qualitative disclosure would help describe the nature of risks undertaken and put the quantitative disclosure in better perspective. It is therefore proposed that the disclosures be enhanced to cover the objectives, policies and strategies for the use of derivatives, and the accounting treatment on derivatives and hedges.

(iii) Breakdown of customer deposits (para. 2.2.1 of FD-1 and para. 2.2.1 of FD-2)

6. Holders of different types of deposits may exhibit different behavioural patterns. The current disclosure requirements only require a one-line disclosure of deposits from customers. It is proposed that this should be further supplemented by an analysis by types of deposits. In order not to create an additional reporting burden, the disclosure breakdown proposed is in line with the reporting by institutions in the banking return MA(BS)1 *Return of Assets and Liabilities*. Institutions may wish to note that with the introduction of hybrid deposit products following interest deregulation, MA(BS)1 has been revised to address the reporting of such products --- hybrid deposit products are proposed to be reported within the demand deposits and current accounts category. The revised MA(BS)1 is presently under consultation and institutions are welcome to comment on the proposed reporting treatment.

(iv) Fees and commission income and expenses and related breakdown (paras. 2.1.1 and 3.5.3 of FD-1 and para. 2.1.1 of FD-2)

7. As fees and commissions are an important source of income and net fees and commissions comprise about 20% of total operating income for the banking sector as a whole, it is proposed that separate disclosure of the gross fees and commission income and expenses be made, in line with international best practices and accounting standards (IAS 30). AIs are also encouraged to provide a breakdown of fees and commission income by product lines.

(v) Repossessed assets³ (paras. 2.7.2, 3.7.9, Appendix H of FD-1 and para. 2.2.13 of FD-2)

8. Upon repossession, some banks continue to record the loans concerned as loans and advances until realisation of the assets repossessed, while others write down the loans concerned and transfer the outstanding balance to other assets. AIs that continue to show such items as part of loans and advances disclose them as part of their problem loans, while those that transfer such items to other assets do not include them as problem loans and often do not separate such amounts from other disclosure items. In the absence of a standard accounting treatment in Hong Kong or internationally for repossessed assets, it is arguable which accounting treatment is more appropriate. To facilitate understanding of the numbers on asset quality, it is proposed that AIs should disclose separately the amount of repossessed assets together with the accounting treatment of such, should repossessed assets be material.

(vi) Breakdown of major balance sheet items by classes of business (para. 3.5.2 of FD-1)

9. Currently disclosure by classes of business is required only of profit and loss information. To provide a better picture of the operations of different classes of business, it is proposed to extend the disclosure items to include operating assets, taking reference from HKSSAP 26 *Segmental Reporting*. It is noted that a similar disclosure is also made of geographical segmental reporting (see para. 3.5.1).

(vii) Other operating expenses (para. 2.1.1 of FD-1 and para. 2.1.1 of FD-2)

10. It is proposed that where categories of expenses included within other operating expenses are material, this should be further analysed (e.g. information technology expenditure has become quite a major component of other expenses for some AIs).

Effective Date

11. The above proposals are intended to apply to relevant AIs incorporated in Hong Kong in respect of their annual accounts and interim financial information disclosure statements ending on or after 31 December 2002.

Hong Kong Monetary Authority
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³ Repossessed assets refer to assets in respect of which AIs have acquired physical access and control either through court proceedings or voluntary actions by the mortgagors concerned (e.g. voluntary surrender of keys by mortgagors in case of properties).