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BANKING LAW AND PRACTICE IN HONG KONG

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TABLE OF CONTENTS

CHAPTER 2 BANK-CUSTOMER RELATIONSHIP

CHAPTER 3 BANKER'S DUTY OF SECRECY

CHAPTER 4 PRIVACY AND DATA PROTECTION

CHAPTER 5 MONEY LAUNDERING

CHAPTER 6 BANK AS DEPOSITORY

CHAPTER 7 BILLS OF EXCHANGE, CHEQUES AND PROMISORY NOTES

CHAPTER 8 OVERDRAFT FACILITIES AND LOANS

CHAPTER 9 GUARANTEES AND INDEMNITIES

CHAPTER 10 TAKING SECURITY

financial services amount to almost $365.9 billion, or 16.6% of the Gross Domestic Product (GDP) in terms of value added.[4]

1.005 The success of the banking and finance industry in Hong Kong is partly attributable to the development of international trade and business.[5] Its socio-political environment has also attracted investors from overseas. Capital movements into and out of Hong Kong are unrestricted and both capital gains and dividends are not taxable.[6]

1.006 Over the past two decades Hong Kong has continued to remain competitive on a global and regional level. Data published by the Bank for International Settlements (BIS) places Hong Kong as the second largest offshore banking centre in the world measured by size of reporting banks' aggregate foreign claims,[7] and Asia's second largest International Banking Centre after Japan.[8] Hong Kong is currently ranked fourth (behind London, New York and Singapore) in the Global Financial Centres Index.[9] Recently, the Bank for International Settlements ranked Hong Kong as the fourth largest over the counter (OTC) foreign exchange derivative market in the world with a net-gross basis daily turnover reaching US$437 billion.[10]

(b) Development of banking

1.007 Shortly after the signing of the Treaty of Nanking in 1842 the British colony was established and trading began to flourish in Hong Kong.[11] At this point banking in Hong Kong was initially undertaken by large merchant firms such as Jardine Matheson & Co., Dent & Co and Russell & Co. whom financed trade by exchanging transactions and buying each other's bills for their remittances.[12] However, by 1866 finance was in demand, particularly by smaller companies who could not always seek finance from their larger competitors, and no fewer than 11 English and Indian joint-stock banks had expanded their operations to Hong Kong. During this period of time banking was

[4] Latest figures up to 2014 available from Census and Statistics Department, The Government of the Hong Kong Special Administrative Region, Second Quarter 2016 (August 2016).

[5] See Berry Fong-Chung Hsu et al, *Financial Markets in Hong Kong: Law and Practice* (Oxford University Press, 2006) pp.16–38.

[6] See generally Inland Revenue Ordinance (Cap.112). For a comprehensive view of tax law in Hong Kong see Deloitte Touche Tohmatsu, *Hong Kong Master Tax Guide2014/15* (23rd edn, CCH Hong Kong, 2014).

[7] Bank for International Settlements, Consolidated Banking Statistics 'Consolidated claims of reporting banks – immediate borrower basis: On individual countries by maturity and sector/Amounts outstanding' End, September 2014 (January 2015).

[8] *Ibid.*

[9] 'The Global Financial Centres Index 19' (March 2016). The Global Financial Centres Index (GFCI) is published by the ZYen group and Long Finance and is a recognised instrument for gauging the attractiveness – both in absolute and in dynamic terms – of financial centres. See http://www.longfinance.net last visited on 10 October 2016.

[10] Bank for International Settlements, Triennial Central Bank Survey 2016: 'Turnover of OTC, foreign exchange derivatives' (April 2016).

[11] Accession to the Treaty of Nanking marked the end of the Opium War. In addition to the cession of Hong Kong Island, China also granted the British access to the ports of Xiamen (formerly Amoy), Fuzhou (Foochow), Ningbo (Ningpo), and Shanghai under the Treaty of Nanking (29 August 1842). Prior to this the British only had access to Guangzhou (Canton).

[12] Such companies were known as "agency houses". See Maurice Collis, *Wayfoong: The Hongkong and Shanghai Banking Corporation* (Faber and Faber Limited London, 1965) p.21.

purely limited to the financing of trade as opposed to providing the general public with retail banking services.[13]

The first bank to establish in Hong Kong was The Oriental Banking Corporation, which was established in 1842 in Bombay under the name of the Bank of Western India. In 1845 the bank moved its headquarters to London and established an unincorporated body with unlimited liability of its members in Hong Kong. It was eventually granted a charter in 1951 and served as the leading bank for many years. Later, in 1884 the bank was wound up as a result of heavy lending against failed coffee crop in Ceylon.[14] 1.008

Although a number of other banks were instrumental in the early days,[15] the Hongkong and Shanghai Banking Corporation has played a significant role in the development of the financial sector and economy of Hong Kong. In 1866, the Hong Kong Shanghai Bank was incorporated in Hong Kong under the new Companies Ordinance with the aim of supporting local and foreign trade.[16] 1.009

(c) Scope of chapter

Familiarity with the policy of banking in Hong Kong is essential to the understanding and application of laws relating to banking. A brief overview of the banking policy in Hong Kong is therefore the first issue that this chapter deals with. This chapter then identifies the relevant constitutional foundations relevant to banking in Hong Kong. It also introduces the legal and regulatory framework in addition to illustrating the basic concepts of supervision of the banking industry in Hong Kong. The main elements regarding authorized institutions in Hong Kong are also set out in this chapter followed by a short introduction to banking and banking business. This chapter then highlights the fundamental rules imposed upon local branches, offices, representative offices, overseas branches and representative offices. Finally, this chapter outlines the main standards imposed by the Basel Committee on Banking Supervision. 1.010

2. Policy

Banking policy is a term that refers to the overall approach to the operation and development of the banking sector. The Government of Hong Kong adheres to the principle of minimal market intervention to provide a favourable business environment. Banking policy is guided strongly by the laissez-faire economic model promoted by the government, however, Hong Kong also adopts international best banking practice due to HKMA's membership with Bank for International Settlements. 1.011

[13] Maurice Collis, *Wayfoong: The Hongkong and Shanghai Banking Corporation* (Faber and Faber Limited London, 1965) pp.6–17.

[14] TK Ghose, *The Banking System of Hong Kong* (Butterworths & Co Asia PTE Ltd Singapore 1987) p.3.

[15] Such banks include but are not limited to the following: The Chartered Mercantile Bank of India, London and China, The Chartered Bank, The Bank of China, see TK Ghose, *Ibid.*, at pp.6–17.

[16] See Frank HH King; David JS King; Catherine E King *The History of the Hongkong and Shanghai Banking Corporation*, Volume IV (Cambridge University Press, 1990).

1.012 The principal function of the HKMA, as the banking supervisor in Hong Kong, is to ensure the general stability and effective operation of the banking sector. In this respect the HKMA can be seen as the gatekeeper of banking policy. With regards to banking policy, the HKMA has stated that

> "...there is a need to enhance the level of competitiveness of the Hong Kong banking market in order to promote greater efficiency and innovation in the market. But at the same time it is important to strengthen the safety and soundness of the banking sector as a whole so that the benefits of increased competition and greater efficiency can be fully realised."[17]

1.013 This statement demonstrates that although a competitive banking regime is pursued in Hong Kong this is not to the detriment of a safe and stable banking system.

3. Constitutional Foundations

1.014 The rule of law, due process and judicial freedom are all major factors that have influenced the success of Hong Kong as an international finance centre. Although China resumed sovereignty of Hong Kong on 1 July 1997 the HKSAR Government has the lawful authority to implement its own laws under the 'One Country, Two Systems' policy, promoted by Deng Xioping.[18] Identifying the legal basis of the powers of the HKSAR Government to implement its own banking laws serves as the background to understanding the legislation that underpins banking in Hong Kong.

(a) Joint declaration

1.015 In 1984, The Joint Declaration between the People's Republic of China (China) and Great Britain on the Question of Hong Kong (the Joint Declaration)[19] was ratified by the British Parliament and the National People's Congress of China. This Joint Declaration sets out the agreed conditions upon which the sovereignty of Hong Kong was returned to China. Under the Joint Declaration, in accordance with the provisions of Article 31 of the Constitution of the People's Republic of China, Hong Kong Special Administrative Region (HKSAR) was to be established upon the resumption of the exercise of sovereignty over Hong Kong. Accordingly, HKSAR would be directly under the authority of the Central People's Government of the People's Republic of China however, it shall enjoy a high degree of autonomy, except in foreign and defence affairs which are the responsibilities of the Central People's Government. The Joint

[17] Hong Kong Monetary Authority, *Policy Response to the Banking Sector Consultancy Study* (1999), 6.

[18] See Yash Ghai, *Hong Kong's New Constitutional Order: The Resumption of Chinese Sovereignty and the Basic Law* (2nd edn, Hong Kong University Press, 1999); Ming Sing (ed), *Politics and Government in Hong Kong Crisis Under Chinese Sovereignty* (Routledge, 2009).

[19] The Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong, 19 December 1984 (Cap.2301). This instrument was not given a chapter number in the Loose-leaf edition of the Laws of Hong Kong. An unofficial reference number, however, is assigned to this instrument in BLIS for identification purposes. This also enables users to carry out a search in relation to this instrument by reference to the unofficial reference number.

Declaration provides that the aforementioned policies, amongst others, are to be set out in a Basic Law and they should remain unchanged for 50 years.

(b) Basic Law

The Basic Law of Hong Kong was duly enacted by the People's Congress on 4 April 1990 and was brought into effect on 1 July 1997.[20] Under the Basic Law the HKSAR is an inalienable part of the People's Republic of China and all powers are authorized by the National People's Congress. Article 2 of the Basic Law specifically provides that the HKSAR is authorized to "exercise a high degree of autonomy and enjoy executive, legislative and independent judicial power, including that of final adjudication". With regard to the legal system, Article 8 of the Basic Law ensures that the laws that were previously in place prior to 1997, including the common law system, rules of equity, ordinances, subordinate legislation and customary law shall remain, other than those that contravene the Basic Law.[21] The degree of stability regarding banking laws and practices is secured under the Basic Law, Article 5, which states that "the previous capitalist system and way of life in place prior to 1997 shall remain unchanged for 50 years". 1.016

In accordance with Article 66 of the Basic Law, the Legislative Council of the HKSAR is denounced as the "legislature of the Region". The powers and functions of the Legislative Council are set out in Article 73 of the Basic Law and include (amongst others) enacting, amending or repealing laws in accordance with the provisions of the Basic Law and legal procedures. This is relevant in that Article 73 of the Basic Law serves as the legal basis for the enactment, amendment or repeal of all laws pertaining to banking and finance. 1.017

The preservation of the status of Hong Kong as an international financial centre is clearly set out in Article 109 of the Basic Law. Accordingly, the Government of the HKSAR must "provide an appropriate economic and legal environment" to maintain Hong Kong's position. To enable the Government of the HKSAR to perform this obligation it is authorized under Article 110 of the Basic Law to "formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with the law." 1.018

Protection is afforded by the Basic law for the continuance of the Hong Kong Dollar as legal tender under Article 111 of the Basic Law. It is further provided in Article 111 of the Basic Law that the Government of HKSAR, if satisfied that Hong Kong currency will continue to be stable, can "authorize banks to issue or to continue to issue Hong Kong currency under statutory authority". The foreign exchange markets, gold, securities, futures and other like finance activities shall continue under Article 112 of the Basic Law and the Hong Kong dollar shall remain a freely convertible currency. Article 113 of the Basic Law authorizes the HKSAR Government to manage and control the Exchange Fund of HKSAR and to regulate the exchange value of the Hong Kong Dollar. 1.019

[20] The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, Adopted at the Third Session of the Seventh National People's Congress on 4 April 1990 ("Basic Law").

[21] Also see Article 18 of the Basic Law, which stipulates that: "The laws in force in the Hong Kong Special Administrative Region shall be this Law, the laws previously in force in Hong Kong as provided for in Article 8 of this Law, and the laws enacted by the legislature of the Region."

(c) Protection of property rights under the Basic Law

1.020 Article 105 of the Basic Law also provides additional rights for the protection of the private ownership of property that did not previously exist under colonial administration.[22] Accordingly, individuals and legal persons may acquire, dispose and inherit property. The right to compensation for the unlawful depravation of property is also protected under that Article 105. Such "property" includes not only real property in the form of land, real estate and personal property in possession such as physical goods/chattels but also choses in action, which include deposits in bank accounts, bonds, debentures, and shares.[23]

4. Legislative Sources

(a) Banking Ordinance

1.021 Banking is a closely regulated industry in Hong Kong.[24] The Banking Ordinance (Cap.155), enacted in 1986,[25] provides for the licensing and regulation of banks and other financial institutions in Hong Kong. The key features of the Banking Ordinance (Cap.155) are that it defines the term "banking business" and sets out the three types of financial institutions that are collectively defined as "authorized institutions" (AIs). The regulation of banks and banking activities under the Banking Ordinance (Cap.155) extends to overseas banks operating in Hong Kong in addition to local banks. In addition to the protection of depositors by the licensing of authorized institutions the aims of the Banking Ordinance are to also promote the general stability and effective working of the banking system and make provision for the supervision of money brokers.

1.022 A considerable amount of subsidiary legislation, in the form of rules and regulations, has been enacted to support the provisions set out in the Banking Ordinance (Cap.155) addressing a variety of matters and to implement international standards in accordance with the Basel Committee on Banking Supervision. In particular, the Banking Capital (Amendment) Rules 2012 (Cap.155L) implement the new regulatory capital standards promulgated by the Basel Committee on Banking Supervision, which are referred to as "Basel III". In the new Banking Capital Rules (Cap.155L), new standards of the minimum capital adequacy ratio applicable to authorized institutions are to be phased in from 2013 to 2019. A more detailed discussion regarding the Basel Committee on Banking Supervision is set out in part 1.8 below.

1.023 Under section 7(3) of the Banking Ordinance (Cap.155), the Hong Kong Monetary Authority (HKMA) is empowered to issue guidelines related to the operation of financial institutions. It is intended that such guidelines shall ensure the maintenance of proper banking standards in Hong Kong. Numerous guidelines have been issued

[22] Albert H Y Chen (1993) 'The Basic Law and the Protection of Property Rights', *Hong Kong Law Journal*, 23(1), pp.31–78.

[23] *Ibid.*, at 42.

[24] Prior to the enactment of the first Banking Ordinance of 1948, banking was unregulated in Hong Kong.

[25] The recent Banking Ordinance was enacted as Ordinance number 27 of 1986 and is now Chapter 155 of the Laws of Hong Kong.

by HKMA, which relate to a wide range of matter including but not limited to authorization, self-regulation and ethics, electronic banking and enforcement.[26]

(b) Exchange fund Ordinance

The establishment and management of the exchange fund and the employment of its assets in Hong Kong is governed by the Exchange Fund Ordinance (Cap.66). The Ordinance provides that the exchange fund shall be under the control of the Financial Secretary and shall be used primarily for such purposes as the Financial Secretary thinks fit. The control of the Financial Secretary shall be exercised in consultation with an Exchange Fund Advisory Committee of which the Financial Secretary shall be ex officio chairman. Section 5A of the Exchange Fund Ordinance (Cap.66) also deals with the appointment of the Monetary Authority. 1.024

(c) Other significant legislation

The Bills of Exchange Ordinance (Cap.19) is an enactment that governs negotiable instruments such as bills of exchange, promissory notes and cheques. The Hong Kong Association of Banks Ordinance (Cap.364); Clearing and Settlement Systems Ordinance (Cap.584); and the Protection of Investors Ordinance (Cap.335) also serve as important sources of Hong Kong banking law. In addition, contracts made between a banker and customer will be governed by key consumer legislation such as the Control of Exemption Clauses Ordinance (Cap.71); the Unconscionable Contracts Ordinance (Cap.458); and the bank must conduct business in accordance with the Supply of Services (Implied Terms) Ordinance (Cap.457). 1.025

To ensure that the bank does not assist its customers, either voluntary or involuntarily, in illicit practices such as money laundering, terrorist financing or harbouring the proceeds of other criminal acts or taxation banks must also comply with relevant legislation such as the: Anti-Money Laundering and Counter Terrorist Financing Ordinance (Cap.615); Drug Trafficking (Recovery of Proceeds) Ordinance (Cap.405); Organized and Serious Crimes Ordinance (Cap.455); and Inland Revenue Ordinance (Cap.112). 1.026

(d) Personal Data Privacy Ordinance

Since banks collect and retain a large amount of personal information pertaining to their customers they are bound by the Personal Data (Privacy) Ordinance (Cap.486) (PDPO). The PDPO does not set out specific requirements on the banking sector however; banks are caught by the PDPO since they qualify as data users. Further discussion regarding the application of data protection laws in the banking industry is set out in Chapter 4. 1.027

(e) Securities and Futures Ordinance

As a consequence of the proliferation of banking services, the modern bank also conducts other activities that are deemed to be outside of the scope of traditional 1.028

[26] Hong Kong Monetary Authority, Guidelines and Circulars, available online at http://www.hkma.gov.hk/eng/key-information/guidelines-and-circulars/guidelines/ last visited on 6 February 2016.

banking business. When a bank is dealing in securities and futures such activity will fall within the regulatory ambit of the Securities and Futures Commission (SFC). The SFC is an independent non-governmental statutory body and acts as the regulator of the securities and futures industry.[27] The Securities and Futures Ordinance (Cap.571) (SFO) serves to ensure the regulation of activities and other matters connected with financial products, the securities and futures market and the securities and futures industry. Accordingly, when carrying out such activities the bank is bound by these provisions. Although the modern bank may carry out business within the securities and futures markets, such dealings are outside of the scope of this publication.[28]

5. Non-Legislative Sources

(a) Code of Banking Practice

1.029 A non-statutory code of practice, the Code of Banking Practice (the Code), is issued jointly by the Hong Kong Association of Banks and Deposit Taking Companies Association, and endorsed by the Hong Kong Monetary Authority.[29] The Code was first issued on 11 July 1997[30] and is subject to review and revision from time to time. The current revised edition is effective from 6 February 2015.[31] Five new paragraphs[32] and 2 new annexes have been added to the 2015 Code. Accordingly, the Code is now structured into two parts (Part I – Introduction and Part II – Recommendations of Banking Practice) comprising 52 paragraphs and 3 annexes.

1.030 The Code is issued on a voluntary basis and must be observed by authorized institutions in dealing with their customers. It is important to note that one key feature of the Code is that it only applies to customers who are private individuals;[33] and therefore it does not apply to corporate customers. The Code specifically deals with banking services such as current accounts, savings accounts, deposit accounts, loans and overdrafts card services, electronic banking services and stored value card services. However, the Code clearly states that the principles apply to the overall relationship between

[27] The Securities and Futures Ordinance was established on 1 May 1989 under the Securities and Futures Commission Ordinance (Cap.24) however, due to the consolidation of a number of Ordinances the existence of the SFC is now based in the Securities and Futures Ordinance (Cap.571), s.3(1). Also see s.5(1) of the SFO which confirms that the SFC is the regulator of securities and sets out the primary duties of the SFC.

[28] See David C Donald, *The Hong Kong Stock and Futures Exchanges* (Sweet & Maxwell, 2012).

[29] The Code of Banking Practice (February 2015) available online at http://www.hkma.gov.hk/media/eng/doc/code_eng.pdf last visited on 18 February 2016.

[30] Hong Kong Monetary authority, Guidelines & Circulars (11 July 1997) available online at http://www.hkma.gov.hk/eng/key-information/guidelines-and-circulars/circulars/1997/circu_110797b.shtml last viewed 18 February 2016.

[31] The Code of Banking Practice (February 2015), para.1.5 states "Institutions should take active steps to comply with the revised provisions as quickly as possible. They should achieve full compliance within 6 months of the effective date. However, a further 6 months will be allowed for compliance with those revised provisions of the Code which require system changes."

[32] The Code of Banking Practice - Newly inserted paragraphs are: para.15 Management of Banking Activities; para.28 Fees and Charges (Card Services); para.29 Interest Rate (Card Services); para.30 Repayment (Card Services); and, para.42 Application (Recovery of Loans and Advances). Annex I contains 'Useful Definitions'. Annex II is new and set outs Ban on Double-Cycle Billing. Annex III is also new and sets out a Recommended Template on Monthly Statements.

[33] The Code of Banking Practice, para.1.2. Also see Annex I 'Useful Definitions' for a definition of "Customer".

institutions and their customers in Hong Kong.[34] The Code must also be observed by any subsidiaries and affiliated companies controlled by authorized institutions when providing banking services in Hong Kong, such as lending, remittance or gold bullion service, in the event that any such subsidiaries or affiliates are not licensed, regulated or supervised by any financial regulators in Hong Kong.

The objectives of the Code are to promote good banking practices by setting out minimum standards; increase transparency in the provision of banking services to private customers; promote a fair treatment of customers; and foster customer confidence in the banking system.[35] Although the Code does not have statutory force the HKMA expects all institutions to comply with the Code and will monitor compliance as part of its regular supervision.[36] Practically, this means that in the event that an authorized institution does not adhere to the Code a customer may challenge that institution for not providing services in accordance with the standards set. 1.031

(b) HKMA statutory guidelines, circulars and technical notes

The Banking Ordinance (Cap.155) empowers the HKMA to issue statutory guidelines regarding the internal operations of authorized institutions.[37] Statutory guidelines set out the minimum standards with which authorized institutions are expected to comply to satisfy the requirements of the Banking Ordinance (Cap.155). The purpose of such guidelines is to ensure compliance with the law and the maintenance of proper standards. In addition to minimum standards, statutory guidelines may also embody best practices or advisory standards. 1.032

Examples of recent Statutory Guidelines include: 1.033

- Guideline on Anti-Money Laundering and Counter Terrorist Financing,[38]
- Guideline on Authorization of Virtual Banks,[39] and
- Guideline on Exercising Power to Impose Pecuniary Penalty.[40]

Statutory guidelines do not themselves have the force of law and are therefore regarded as "soft law". However, failure to adhere to a statutory guideline may cause the Monetary Authority to question whether the AI concerned continues to satisfy the minimum criteria for authorization under the Banking Ordinance (Cap.155).[41] 1.034

To encourage authorized institutions to implement the monetary policy set by the Government the HKMA also issues circulars/guidance notes and technical notes. Non-statutory guidelines issued to AIs as circulars or guidance notes are best practice guides setting out the HKMA's recommendations to authorized institutions in respect 1.035

[34] The Code of Banking Practice, para.1.2.

[35] The Code of Banking Practice, para.3.1(a)-3.1(d).

[36] The Code of Banking Practice, para.1.4.

[37] Banking Ordinance (Cap.155), ss.7(3), 16(10), and 118C(7).

[38] Guideline on Anti-Money Laundering and Counter Terrorist Financing, July 2012.

[39] Guideline on Authorization of Virtual Banks, 21 September 2012.

[40] Guideline on Exercising Power to Impose Pecuniary Penalty, 29 June 2012.

[41] See 'Authorized Institutions' below.

of the standards they should aim to achieve. Technical Notes are usually technical in nature and are for the purpose of clarifying the HKMA's interpretation of regulatory and reporting issues. Non-compliance with any circular, guideline or technical note may call into question whether the authorized institution concerned continues to satisfy the minimum criteria for authorization.[42]

(c) Supervisory Policy Manual

1.036 The HKMA has issued a Supervisory Policy Manual which is based on the model prepared by the Basel Committee on Banking Supervision.[43] The Supervisory Policy Manual sets out the HKMA's supervisory policies and practices, the minimum standards authorized institutions are expected to attain in order to satisfy the requirements of the Banking Ordinance and recommendations on best practices. The HKMA requires all authorized institutions to comply with the minimum standards set out in the Supervisory Policy Manual and encourages them to aim for the best practice to suit their business needs.

6. Supervision

(a) Hong Kong Monetary Authority

1.037 Most countries have a Central Bank, which implement monetary and credit policy, act as principal banker to the government, a lender of last resort, and undertake supervisory and regulatory responsibility over the banking sector.[44]

1.038 Hong Kong, however, does not have a Central Bank, although the functions of the Central Bank are carried out by a number of organisations. In terms of the issuance of currency in Hong Kong this role of the Central Bank is performed partly by the Financial Secretary with the approval of the Chief Executive, and partly by the note-issuing banks,[45] namely the Hong Kong and Shanghai Banking Corporation (HSBC), Standard Chartered Bank and the Bank of China Hong Kong Branch.[46] However, the HKMA functions in a similar way to a Central Bank with regard to supervisory and regulatory activities.[47] This means that the HKMA formulates and implements monetary policy, supervises authorized institutions, develops financial market infrastructure and promotes external relations with other authorities.

1.039 The Hong Kong Monetary Authority (HKMA) was established on 1 April 1993 by merging the Office of the Exchange Fund with the Office of the Commissioner of

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42 *Ibid.*

43 Hong Kong Monetary Authority, Supervisory Policy Manual: available online at http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/IN.pdf last viewed on 18 February 2016.

44 For example, in the United States the central bank is The Federal Reserve; In the United Kingdom it is the Bank of England; Australia has the Reserve Bank of Australia; and, New Zealand has the Reserve Bank of New Zealand. On the role of central banks see Mark Hsiao, *International Banking & Finance Law: Principles and Regulations* (Sweet & Maxwell, 2011) pp.23–24.

45 Legal Tender Notes Issue Ordinance (Cap.65), s.3.

46 Note-issuing bank is defined in the Legal Tender Notes Issue Ordinance (Cap.65), s.2.

47 On operations of Central Banks and the Hong Kong Monetary Authority. See Simon S M Ho *et al*, *The Hong Kong Financial System: A New Age* (Oxford University Press, 2004) pp.34–43; Ian Tolkey *Banking Law: Hong Kong and People's Republic of China* (LexisNexis Butterworths, 2014) pp.101–104.

Banking. It is the government authority responsible for maintaining monetary and banking stability in Hong Kong under the Banking Ordinance. The HKMA also manages the Exchange Fund in accordance with the Exchange Fund Ordinance (Cap.66) under the powers granted by the Financial Secretary. The functions of the HKMA, with regards to the Exchange Fund, are set out in the Exchange Fund Ordinance (Cap.66).[48] In accordance with section 5A of the Exchange Fund Ordinance (Cap.66), the Monetary Authority is an individual appointed by the Financial Secretary. Legally, that person is the Monetary Authority (Chief Executive of the HKMA). In practice, it is the HKMA that carries out the functions of the Monetary Authority.

(b) Objectives and functions of HKMA as banking supervisor

The HKMA derives its powers to supervise banking from the Banking Ordinance. It is stated in section 7(1) of the Banking Ordinance (Cap.155) that the principal function of the Monetary Authority is to: "promote the general stability and effective working of the banking system". 1.040

The objectives and further functions of the HKMA are set out in section 7(2) of the Banking Ordinance (Cap.155) as follows: 1.041

(a) be responsible for supervising compliance with the provisions of the Ordinance;

(b) take all reasonable steps to ensure that the principal places of business, local branches, local offices, overseas branches and overseas representative offices of all authorized institutions and local representative offices are operated in a responsible, honest and business-like manner;

(c) promote and encourage proper standards of conduct and sound and prudent business practices amongst authorized institutions and money brokers;

(d) suppress or aid in suppressing illegal, dishonourable or improper practices in relation to the business practices of authorized institutions;

(e) co-operate with and assist recognised financial services supervisory authorities of Hong Kong or of any place outside Hong Kong, whenever appropriate, to the extent permitted by this or any other Ordinance;

(f) consider and propose reforms of the law relating to banking business and the business of taking deposits; and

(g) take all reasonable steps to ensure that any banking business, any business of taking deposits, or any other business, carried on by an authorized institution is carried on:

   (i) with integrity, prudence and the appropriate degree of professional competence; and

   (ii) in a manner which is not detrimental, or likely to be detrimental, to the interests of depositors or potential depositors.

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48 Exchange Fund Ordinance (Cap.66), s.5A.

1.042 To ensure that the HKMA can carry out its objectives and functions in accordance with section 7 of the Banking Ordinance (Cap.155), a regulatory framework in line with international standards, particularly those recommended by the Basel Committee on Banking Supervision is adopted. The HKMA therefore operates a prudential supervisory system, which aims to preserve the general stability and effective working of the banking system, while at the same time provides a degree of flexibility to allow authorized institutions to make commercial decisions. The Basel Committee on Banking Supervision is discussed in further detail below.

(c) CAMEL rating system

1.043 The supervision of authorized institutions by the HKMA is conducted in accordance with international practices. To detect any problems at an early stage the HKMA operates a policy of supervisory risk assessment and early warning system. This risk-based approach involves through on-site examinations, off-site reviews, prudential meetings, co-operation with external auditors and sharing information with other supervisors.[49]

1.044 The HKMA has adopted the CAMEL rating system to assess the financial position and overall soundness of authorized institutions. The CAMEL rating system is a formal, structured and quantified assessment not only of the financial performance of authorized institutions but also of the underlying risk profile and risk management capabilities of individual institutions. The CAMEL rating system was first introduced in the United States in the 1980s as a uniform system of rating a banking institution in the United States. Under this system each authorized institution is subject to an on-site examination, which is evaluated on the basis of five (now six in the United States) critical dimensions relating to its operations and performance. These dimensions are referred to as the component factors and include the following:

C – Capital

A – Asset Quality

M – Management

E – Earnings, and

L – Liquidity[50]

1.045 The overall rating is scaled from 1, representing the highest performance and least degree of concern to 5, the lowest performance and highest degree of concern. The

[49] On the supervisory approach of on-site examinations, off-site reviews, prudential meetings and tripartite meetings with external auditors see Hong Kong Monetary Authority, "Regulatory Framework" available online at http://www.hkma.gov.hk/eng/key-functions/banking-stability/banking-policy-and-supervision/regulatory-framework.shtml last viewed on 20 February 2016.

[50] In 1996, in an effort to make the rating system more risk-focused, a sixth component relating to Sensitivity to market risk was added to the CAMEL rating in the United States, making it CAMELS. On CAMELS rating see Ranjana Sahajwala & Paul Van den Bergh "Supervisory Risk Assessment and Early Warning Systems" Basel Committee on Banking Supervision Working Paper, (No. 4 December 2004).

CAMEL rating system helps the HKMA to identify institutions whose weaknesses in financial condition, compliance with laws and regulations, and overall operating soundness require special supervisory attention.

(d) Loan classification system

Authorized institutions must report their assets on a quarterly basis to the HKMA according to a standardised framework under the Loan Classification System. The system was introduced in 1994 and requires the reporting of loans, including investment debt securities, and provisions made against them under the following five categories: pass, special mention, substandard, doubtful and loss. 1.046

Table 1.1: Loan classification system

Pass	Loans for which borrowers are current in meeting commitments and for which the full repayment of interest and principal is not in doubt.
Special mention	Loans with which borrowers are experiencing difficulties and which may threaten the authorized institution's position.
Substandard	Loans in which borrowers are displaying a definable weakness that is likely to jeopardise repayment.
Doubtful	Loans for which collection in full is improbable and the authorized institution expects to sustain a loss of principal and/or interest, taking into account the net realisable value of collateral
Loss	Loans that are considered uncollectable after all collection options (such as the realisation of collateral or the institution of legal proceedings) have been exhausted.

Under the system, loans that fall within the Substandard, Doubtful or Loss category are collectively regarded as "classified assets". 1.047

The Loan Classification System was implemented to provide the HKMA with intelligence regarding the asset quality of authorized institutions and to generate a synopsis of the asset quality of the banking industry in Hong Kong as a whole. The Loan Classification System is reinforced by regular reporting on provisions set aside for each category of classified assets and for different sectors in Hong Kong.[51] 1.048

(e) Collection of prudential data

The Monetary Authority's powers to collect prudential data from authorized institutions on a routine or ad hoc basis are set out in section 63 of the Banking Ordinance (Cap.155). All authorized institutions are required to submit a return showing the 1.049

[51] Hong Kong Monetary Authority, "Regulatory Framework" available online at http://www.hkma.gov.hk/eng/key-functions/banking-stability/banking-policy-and-supervision/regulatory-framework.shtml last viewed on 20 February 2016.

assets and liabilities of its principal place of business in Hong Kong and all local branches at the close of business on the last business day or last day of that month.[52] A quarterly return must also be submitted to the HKMA no later than 14 days after 31 March, 30 June, 30 September and 31 December.[53] Each director, chief executive and manager that contravenes section 63(1) of the Banking Ordinance (Cap.155), without reasonable excuse, commits an offence and is liable on conviction upon indictment or on summary conviction to a fine at tier 5.[54]

1.050 Section 63(2) of the Banking Ordinance (Cap.155) gives the HKMA very broad powers to enquire into the affairs of an authorized institution. The Monetary Authority may request the submission of any further information that he may reasonably require for the exercise of his functions under the Ordinance. The broad powers to enquire are not limited to the affairs of the authorized institution but also extend to the affairs of its holding company, subsidiary and any subsidiary of its holding company.[55] Contravention of sections 63(2) and 63(2A) of the Banking Ordinance (Cap.155) could render liability on conviction upon indictment to a fine at tier 7 and imprisonment for 2 years, or on summary conviction to a fine at tier 5 and to imprisonment for 6 months.[56]

(f) Reporting to Financial Secretary

1.051 In accordance with section 9(1) of the Banking Ordinance (Cap.155), the Chief Executive of HKMA must, as soon as practicable after each 31 December, prepare and furnish to the Financial Secretary a report on the working of the Banking Ordinance and on the activities of his office during the preceding year and, in that report, may set out any measures that he considers necessary for improving the working of the Banking Ordinance and of the activities of his office. In that report, the Chief Executive of the HKMA must draw attention to any breach or avoidance of the Banking Ordinance that has come to their notice during the preceding year or any irregularity discovered in the accounts and records of the financial transactions of any authorized institution for that period which is, in their opinion, of sufficient importance to justify taking such action.[57]

1.052 Reporting is not merely restricted to an annual report since the Chief Executive may, at any time, request the Monetary Authority to report to him on any matter relating to the working of the Ordinance or the activities of the office of the Monetary Authority, and the Monetary Authority shall, forthwith, prepare and furnish a report to the Chief Executive accordingly.[58]

[52] Banking Ordinance (Cap.155), s.63(1).
[53] A full list of returns and completion instructions are provided by Hong Kong Monetary Authority online at http://www.hkma.gov.hk/eng/key-functions/banking-stability/banking-policy-and-supervision/regulatory-framework.shtml last viewed on 20 February 2016.
[54] Banking Ordinance (Cap.155), s.63(5).
[55] Banking Ordinance (Cap.155), s.63(2A).
[56] Banking Ordinance (Cap.155), s.63(6).
[57] Banking Ordinance (Cap.155), s.9(2).
[58] Banking Ordinance (Cap.155), s.9(4).

(g) Hong Kong Association of Banks

The Hong Kong Association of Banks (HKAB) is a statutory body incorporated in 1981 under The Hong Kong Association of Banks Ordinance (Cap.364). The Ordinance provides a framework for the Government to exchange views with the banking sector for the further development of the industry. The Committee is the highest executive body of HKAB, which directs and decides the business and policies of the Association. There are 3 permanent committee members of the HKAB, namely HSBC, the Standard Chartered Bank and the Bank of China, Hong Kong Branch.[59] A further 9 elected members consists of 4 members, whose place of incorporation is Hong Kong and 5 members, whose place of incorporation is outside Hong Kong.[60] 1.053

All licensed banks are obliged to become a member of the HKAB and are therefore subject to the rules of the Association.[61] It is the bank that takes up membership of the association, not the employees of the bank. HKAB is under the auspices of its member banks, which are represented by their designated representatives in general meetings. A senior executive must be designated by each member bank to represent it at HKAB at meetings. 1.054

The main aim of the HKAB is to further the interests of licensed banks. Further objects of the HKAB are set out in section 4 of The Hong Kong Association of Banks Ordinance (Cap.364) and include but are not limited to the following: 1.055

i) promote, consider, support, oppose, make representations as to and generally, deal with any law affecting or likely to affect the business of banking
ii) making rules from time to time for the conduct of the business of banking, and
iii) to act as an advisory body to its members and to co-operate and maintain relations with other bodies and organizations in all matters touching or concerning the business of banking.

In brief, the HKAB exercises informal control over the activities of licensed banks. The HKAB has the power to consider, investigate and enquire into any questions or matters related to banking business of licensed banks.[62] 1.056

(h) Supervision of other services

The supervisory powers of the HKMA under the Banking Ordinance (Cap.155) only extend to banking services.[63] In practice, the modern bank performs many roles outside of the scope of banking services, which includes providing investment advice, dealing in securities and futures or providing insurance services. Should the bank offer any 1.057

[59] Hong Kong Association of Banks Ordinance (Cap.364), s.8(1)(a).
[60] Hong Kong Association of Banks Ordinance (Cap.364), s.8(1)(b)(i) and 8(1)(b)(ii).
[61] Hong Kong Association of Banks Ordinance (Cap.364), s.7(1).
[62] See Mark Hsiao, *Principles of Hong Kong Banking Law* (Sweet & Maxwell, 2013), pp.14–18.
[63] Banking services includes the business of operating current accounts, savings and other deposit accounts, loans and overdrafts, card services, electronic banking services and stored value card services. See 1.07 for discussion related to 'Bank, Banking and Banking Business' below.

such services, then those services will be regulated by the appropriate body such as the Securities and Futures Commission[64] or the Office of Commissioner of Insurance.[65]

7. Bank and Banking Business

1.058 The terms "bank" and "banking business" are defined in section 2 of the Banking Ordinance (Cap.155). However, these definitions will only apply within the context of the Banking Ordinance (Cap.155) as different statutes define terms for their own specific purposes.[66] This means that an institution that may be deemed to be a bank in one statutory context may not be regarded as such in another. The common law meaning of "bank", "banker" and "banking business" are relevant in Hong Kong for two main reasons: First, a banker within the common law meaning has the right of lien and set off; and secondly, some ordinances refer to these terms without providing a definition. This part simply identifies the statutory definitions of "bank" and "banking business" under the Banking Ordinance. Other statutory definitions and the common law meaning of "banker" and "banking business" are discussed in Chapter 2.[67]

(a) Bank

1.059 Under section 2 of the Banking Ordinance (Cap.155), a "bank" is deemed to be a company, which holds a valid banking licence. The term "Banking Licence" is further defined as a banking licence granted under section 16 of the Banking Ordinance (Cap.155). The licensing of banks is discussed further below in part 1.08. Any person not being a licenced bank or a central bank of another jurisdiction, who uses the word "bank" without the written permission of HKMA commits an offence and is liable on conviction upon indictment to a fine at tier 7 and to imprisonment for 2 years, or on summary conviction to a fine at tier 5 and to imprisonment for 6 months.[68]

(b) Banking business

1.060 According to section 2 of the Banking Ordinance (Cap.155), "banking business":

> Means the business of *either* or *both* of the following:
>
> (a) receiving from the general public money on current, deposit, savings or other similar account repayable on demand or within less than the period specified in item 1 of the First Schedule or with a period of call or notice of less than that period;
>
> (b) paying or collecting cheques drawn by or paid in by customers.

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[64] See Securities and Futures Ordinance (Cap.571).
[65] See Insurance Companies Ordinance (Cap.41) and Robert Merkin, *Colinvaux's Law of Insurance Hong Kong* (2nd edn, Sweet & Maxwell, 2014).
[66] See, for example, Bills of Exchange Ordinance (Cap.19), s.2: "banker" extends to a body of persons, regardless of incorporation, who carry on the business of banking. See, Chapter 2 'Bank Customer Relationship'.
[67] See, Chapter 2 'Bank-Customer Relationship'.
[68] Banking Ordinance (Cap.155), s.97(1)(a) and 97(1)(b).

When applying for a banking licence in Hong Kong the institution must satisfy the HKMA that it will perform one or both of the functions stated in the definition of "banking business".[69] In practice, banks will perform both functions in addition to many other services including providing loans and overdrafts, card services, electronic banking services, stored value card services, safe custody and investment advice. 1.061

8. Authorized Institutions

Banking business and the business of taking deposits is to be carried on by authorized institutions only. According to section 2 of the Banking Ordinance (Cap.155), an "authorized institution" means a bank (licenced bank), restricted licence bank (RLB) or deposit taking company (DTC). This gives rise to a three-tier system of institutions with different restrictions imposed upon their activity.[70] 1.062

The Monetary Authority has the discretion to grant or refuse authorization on receipt of an application from the company according to the criteria set out in the Seventh Schedule of the Banking Ordinance (Cap.155).[71] If such criteria are satisfied, the Monetary Authority may grant a banking licence where the company intends to carry on banking business, a restricted banking licence where the company intends to carry on the business of taking deposits as a restricted licence bank and where the company intends to carry on a business taking deposits as a deposit taking company the particulars of that company shall be registered.[72] The criteria set out in the Seventh Schedule of the Banking Ordinance (Cap.155) is in compliance with the international standards set by the Basel Committee on Banking Supervision, Basel III and largely applies to all authorized institutions with some important exceptions which are discussed below. 1.063

(a) Licensed bank

Banking business[73] is restricted to licensed banks holding a valid licence granted under section 16 of the Banking Ordinance (Cap.155).[74] The sanctions for breaching this restriction are severe and every manager and director of that company who contravenes this rule faces a conviction upon indictment which attracts a maximum prison sentence of 5 years and a hefty fine.[75] Commercial banks that offer banking services to the general public fall within the category of licensed banks and they may provide comprehensive banking services to the public without specific restrictions as to the amount of deposits that need to be placed or the period of maturity. As soon as a company is authorized as a licensed bank, that bank must become a member of the Hong Kong Association of Banks (HKAB) and shall become subject to the rules of HKAB.[76] 1.064

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[69] On "carrying on business" see, *Kirkwood v Gadd* [1910] AC 422; see also *Smith v Anderson* 15 Ch D 247; *R v Lin Kuo Liang, David* [1997] HKLRD 694; *Erichsen v Last* 8 QBD 414.
[70] Banking Ordinance (Cap.155), s.2.
[71] Banking Ordinance (Cap.155), s.16(1).
[72] Banking Ordinance (Cap.155), s.3.
[73] As defined in the Banking Ordinance (Cap.155), s.2.
[74] Banking Ordinance (Cap.155), s.11(1).
[75] Banking Ordinance (Cap.155), s.11(2)(a) and 11(2)(b).
[76] Hong Kong Association of Banks Ordinance (Cap.364).