

G.N. 7144

## **BANKING ORDINANCE**

### **Deposit Guarantee and Contingent Bank Capital Facility A Guideline issued by the Monetary Authority under section 7(3)**

This is a guideline issued under section 7(3) of the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) which provides that the Monetary Authority (MA) may from time to time cause to be prepared and published by notice in the Gazette guidelines indicating the manner in which he proposes to exercise functions conferred or imposed upon him by or under the Banking Ordinance.

The Financial Secretary announced on 14 October 2008 that the Exchange Fund would be used to : (a) guarantee the repayment of all customer deposits with all authorized institutions (AIs) in Hong Kong<sup>1</sup> (Guarantee) and (b) establish a Contingent Bank Capital Facility (Facility) to make additional capital available to locally incorporated licensed banks. The MA is mindful of the potential “moral hazard” that might be engendered by the availability of the Guarantee and the Facility, in the sense of their misuse to undertake activities without sufficient regard to the concomitant risks.

Section 7(1) of the Banking Ordinance provides that the principal function of the MA is to promote the general stability and effective working of the banking system.

Section 7(2) of the Banking Ordinance charges the MA with responsibility for, amongst other things :

- taking all reasonable steps to ensure that the places of business, branches and offices of AIs are operated in a responsible, honest and business-like manner;
- promoting and encouraging proper standards of conduct and sound and prudent business practices amongst AIs; and
- suppressing or aiding in suppressing illegal, dishonourable or improper practices in relation to the business practices of AIs.

The MA therefore has a strong interest in ensuring that AIs continue to conduct their business in a sound and prudent manner and refrain from engaging in imprudent business activities or practices carrying significantly more risk than they would otherwise be inclined to undertake in the absence of the Guarantee

---

<sup>1</sup> The guarantee covers all protected deposits as defined in the Deposit Protection Scheme Ordinance (Cap 581) were that Ordinance to apply to all AIs.

and the Facility. The MA will be particularly vigilant whilst the Guarantee and Facility remain in place to detect any such activities or practices.

To counter any potential “moral hazard” effects, the MA will be enhancing his monitoring of the activities of AIs with a view to pre-empting the emergence of any imprudent business practices. Specifically, the MA will scrutinize carefully any behaviour of, or circumstances pertaining to, an AI which may be potentially indicative of a degree of moral hazard, including but not limited to :

- any unexpected increases in deposit base markedly out of step with the general condition or position of, or trend in respect of, that institution prevailing in the twelve month period to the end of June 2008. For instance, in the case of a marked increase of deposits “booked” with the institution from customers outside Hong Kong, the MA will expect the institution to explain the rationale behind the taking of such offshore deposits;
- any solicitations of deposits by the offering of benefits or interest rates materially more generous, in relative terms by reference to industry benchmarks and the like, to those offered by the institution in the twelve month period to the end of June 2008;
- any unexpected material increases in the levels of the institution’s financial exposures and the risks associated with such exposures (including any indications of imprudent pricing of risk) relative to the generally prevailing condition or position of, or trend in respect of, that institution in the twelve month period to the end of June 2008;
- any unjustified relaxation of any of the institution’s existing corporate governance, risk management or other control systems, including in particular but not limited to credit underwriting criteria and investment strategy;
- any material deviation from the institution’s established business goals and strategies and risk appetite; and
- any marked declines in the institution’s capital adequacy ratio or other supervisory ratios.

The Board of Directors and senior management of an AI are ultimately responsible for the operations and financial soundness of the institution and will be expected to exercise adequate oversight over the activities and practices of the institution to guard against the emergence of any imprudent business activities or practices.

The conduct of business by an AI in an imprudent or improper manner may cast doubt on the fitness and propriety of individual directors and members of the management team of the AI or may call into question whether the AI continues to satisfy the minimum criteria for authorization in the Banking Ordinance.

Further, in view of the public interest in pre-empting or minimising imprudent conduct in the circumstances described above, if an AI is found to have relied on, and so misused, the Guarantee and the Facility to engage in business activities or practices involving an imprudent degree of risk, the MA may, where he considers it necessary, impose directions under section 52(1)(A) of the Banking Ordinance to restrain any such conduct which comes to the MA's attention.

To enable the MA to exercise his functions as referred to in this guideline more effectively, AIs should notify the MA in advance before embarking upon (i) any new line of business not previously conducted by them or (ii) any plan for expansion of an existing line of business by increasing the level or size of such business prevailing at the end of June 2008 at an annual rate of 10% or more.

In the current challenging environment for financial institutions, AIs should endeavour to enhance their risk management practices and should remain vigilant to the risks they undertake.

*24 October 2008*

*Monetary Authority*