

Box 4. Findings of the Financial Sector Assessment Program

Overall, the assessment confirms that the Hong Kong SAR financial system is robust and fundamentally sound. Hong Kong SAR's financial system has shown resilience in the midst of recent international financial crises and during the domestic cyclical downturn. While some improvements in financial sector supervision and regulatory governance arrangements are recommended, no immediate issues of systemic instability are apparent.

Financial markets are well-developed, liquid, and efficient. The banking system, in particular, is well capitalized and profitable. However, weak demand for corporate loans and declining interest rate margins on mortgage loans are driving banks, even smaller ones, to expand into investment banking, securities brokerage, insurance brokerage, and asset management services. Linkages of the banking sector with the capital markets and insurance sectors are growing, motivating enhanced supervisory coordination among regulators of the banking, insurance and securities industries. This also highlights the need to strengthen legislation related to regulatory and insolvency procedures for financial conglomerates. The recently established Mandatory Provident Fund will help to develop the local capital market, but faces structural challenges stemming from its low current returns and a projected income replacement rate that is within international norms, but that depends on maintaining the present contribution rates, long service in the system, and nonwithdrawal of funds upon separation.

The assessment finds that the necessary regulatory infrastructure is in place to support the efficient functioning of financial markets. Nevertheless, governance of the securities settlement system (SSS) would benefit from greater stakeholder participation. As with the SSS for securities transfer, the payments system would also benefit from approval of pending legislation to ensure finality of settlements in funds transfer. In the area of corporate governance, fostering wider shareholder participation would help ensure equitable treatment of minority shareholders, especially in view of the concentrated ownership structures. The Report by the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure, released in March 2003, has made a number of recommendations to strengthen the regulatory structure. The government broadly considers the recommendations to be appropriate and is currently reviewing them. It is also reviewing the feasibility of transferring the listing function from Hong Kong Exchanges and Clearing to the Securities and Futures Commission (SFC). Prompt approval of these proposed changes would clarify regulatory roles and strengthen enforcement in oversight of the equities market. The accounting and auditing professions and practices are adequate to support a market-based financial system; emphasis should be placed on improved corporate disclosure requirements and enhanced disciplinary procedures in cases of professional misconduct.

The supervisory framework in Hong Kong SAR, which is well developed by international standards, is evolving rapidly from a regulatory compliance focus toward addressing prudential and market conduct issues, and comprehensively assessing financial intermediaries' risk management capabilities and contingency plans. Coordinated supervisory contingency planning, stress testing, and the use of early-warning indicators are welcomed recent developments. The SFC and the HKMA have developed effective information-sharing arrangements, including with foreign regulators and offshore centers. Oversight and regulation of the life insurance sector has been strengthened but may still pose some risks related to excessive supervisory reliance on actuaries and self-regulatory organizations. Data collection could be further improved to enable better assessment of market risk and profitability of the life insurance sector.

The assessment recommends further strengthening of regulatory governance arrangements dealing with systemic and financial stability issues. Cross-sector and system-wide regulatory responsibilities can be better clarified and made public, the monitoring of factors affecting financial stability can be strengthened, and the collection of data on a system-wide basis can be improved. The transparency of institutional and policy frameworks for financial and systemic stability could be further enhanced by publishing the Terms of Reference of the high-level Council of Financial Regulators, and by formalizing accountability and disclosure procedures in dealings between the Chief Executive of Hong Kong SAR and the Financial Secretary.

Hong Kong SAR has largely put in place a framework for Anti-Money Laundering and Combating the Financing of Terrorism that is in accordance with the Financial Action Task Force (FATF) recommendations. The banking, securities, and insurance authorities have issued guidelines on the prevention of money laundering since enactment of the anti-money laundering legislation in 1989, with a number of subsequent revisions. Recently, the authorities have issued for industry consultation proposed supplements, primarily aimed at updating existing guidelines to reflect legislative changes and/or to conform with international standards set out by the Basel Committee and with certain recommendations currently under review by the FATF.