INSOLVENCY SYSTEMS AND RISK MANAGEMENT IN ASIA

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TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT: THE EXPERIENCE OF HONG KONG

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THE EXPERIENCE OF HONG KONG

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Introduction and summary

On 1 July 1997, Hong Kong became a Special Administrative Region of the People’s Republic of China under the “one country, two systems” approach embedded in the Basic Law (Hong Kong’s constitution). Although part of China, Hong Kong retains a common law commercial structure with English origins. Hong Kong’s insolvency laws are in the midst of reform – dramatic changes to bankruptcy law came into operation in 1998, several (albeit unsuccessful) attempts have been made to enact a corporate rescue procedure called provisional supervision, and substantial amendments to corporate liquidation law are likely to be enacted within the next few years.

In Hong Kong, different laws apply to the insolvency of individuals and companies. Personal insolvency law is contained in the Bankruptcy Ordinance, as amended by the Bankruptcy (Amendment) Ordinance 1996, which came into operation on 1 April 1998. Corporate insolvency law is contained in the Companies Ordinance. A liquidation is also called a winding-up; there are two types of liquidation procedures – voluntary winding up (a winding up without a court order) and winding up by the court (compulsory winding up). The discussion of corporate insolvency below will focus on compulsory liquidations and the proposed provisional supervision procedure.

The most significant on-going debate in Hong Kong regarding insolvency centres on the proposed enactment of the controversial provisional supervision procedure. Unlike almost every other jurisdiction in the region, Hong Kong still lacks an effective formal insolvency procedure for restructuring or rehabilitating companies. It is unclear at this stage whether the legislation will ever get enacted. The pendulum has swung back and forth many times on this issue, and at present it again appears that provisional supervision will not be enacted.

In the absence of an effective corporate rescue law, there have been two developments in Hong Kong that have filled the void. First of all, in April 1998 the Hong Kong Association of Banks (HKAB) issued guidelines for corporate restructuring in multi-bank situations based on the well-known London Approach. In 1999 these guidelines were revised and extended in the form of joint guidelines issued by the HKAB and the Hong Kong Monetary Authority (HKMA) and are known as the Hong Kong Approach to Corporate Difficulties. (See HKMA QUARTERLY BULLETIN 13 (11/1999). These guidelines have proved useful in practice.

The second development, and one of the most significant recent judicial developments in Hong Kong insolvency law, has been the adoption by the courts of the provisional liquidation procedure for use in corporate reorganizations. Traditionally, provisional liquidation is an interim period during which the assets of a company are protected while the court considers the merits of making a winding-up order. However, in Re Keyview Technology (BVI) Ltd [2002] 2 HKLRD 290 (Keyview), the court extended the provisional liquidators’ powers and enabled the provisional liquidators to participate in a restructuring. (In Keyview the provisional liquidators first secured the agreement of all the company’s creditors to a restructuring proposal before applying to the court for an extension of their powers and permission to participate in the restructuring.) Over the last two years, the use of provisional liquidation to facilitate corporate rescue has become generally accepted in Hong Kong, and the holding of Keyview has been extended by the courts in several cases, including Luen Cheong Tai International Holdings Ltd [2002] 3 HKLRD 610, Re I-China Holdings Ltd [2002] HKCFI 1357, and Re Fujian Group Ltd [2003] HKCFI
36. These cases make it clear that provisional liquidators can be appointed at the outset to facilitate a corporate rescue. The irony is that the courts’ creativity in fashioning provisional liquidation as a corporate rescue procedure is now raised by many as a factor against the need for the enactment of provisional supervision.

Another important recent case is the decision in August 2004 in *Re Zhu Kuan Group Co Ltd* (HCCW 874/2003) in which the Hong Kong High Court wound up the Zhu Kuan Group Co Ltd (“ZK Group”), which was incorporated in Macau and had served as a “window company” for the Zhuhai Municipal Government. The decision offers the most in-depth discussion to date of the factors for a HK court to apply when deciding whether to wind up a foreign company as an “unregistered company” under Part X of the Companies Ordinance. The court wound up the ZK Group even though winding-up proceedings were also underway in Macau; counsel for the petitioner stressed that the making of the winding-up order would enable the liquidators to use the private examination power under s 221 of the Companies Ordinance and thereby perhaps locate undisclosed assets.

**A. TRENDS AND DEVELOPMENTS IN INSOLVENCY AND CREDITOR RIGHTS FRAMEWORKS AND PRACTICES**

I. Current legal and institutional developments

As noted above, the most contentious area of insolvency law reform in Hong Kong involves corporate rescue. Provisional supervision recommendations were first made by the Law Reform Commission’s Sub-Committee on Insolvency in its 1995 Consultation Paper and by the Law Reform Commission (LRC) in its 1996 Report. Serious opposition arose to many aspects of the government’s proposal in its first bill in January 2000, which differed in several important respects from the earlier recommendations of the LRC and its Insolvency Sub-Committee. The government’s second bill proposing provisional supervision, gazetted in 2001 (The Companies (Corporate Rescue) Bill, Legal Supplement No 3 to the HKSAR Gazette No 20 (Vol 5), 18 May 2001) continues to attract opposition, primarily because of its approach to resolving the issue of workers’ rights (discussed below). The current consensus is that the bill will not be enacted.

At present, the only statutory mechanism available in Hong Kong to enable a company in financial distress to re-structure is a scheme of arrangement pursuant to section 166 of the Companies Ordinance (a replica of the UK scheme of arrangement procedure), which was not specifically designed for insolvency reorganizations. This procedure is expensive, requires many court hearings, does not include a moratorium (unless commenced during provisional liquidation), and is rarely used in practice.

The LRC’s proposals for a new provisional supervision regime were intended to streamline the corporate rescue process, with the use of a moratorium and minimal court involvement. A company, without going to court, would be able to appoint a suitably qualified professional – normally an accountant with extensive insolvency experience – to take over the management of the company and to ascertain whether a rescue plan was feasible. If so, a rescue proposal would be put to the creditors for their approval (two-thirds in value of the creditors present and voting in one single class). To increase the odds of the rescue succeeding, super-priority funding would be available and give the post-commencement lender priority over all other debts except a fixed charge.

The January 2000 bill almost immediately came under attack, primarily for its handling of wage and other claims owed to a company’s workers. The bill – in variance from the LRC’s proposals – proposed that a company would either have to pay, in full, all wages and other entitlements owing to the workers, or set up a trust account with sufficient funds at a bank, before the company could go into provisional supervision. The main objection to this proposal was how a company in financial distress was going to raise sufficient amounts to pay in full, and in advance, all outstanding workers’ claims. (For an alternative proposal for how to handle workers’ claims in provisional supervision, see Philip Smart & Charles D. Booth, *Provisional Supervision and Workers’ Wages: An Alternative Proposal*, 31 HONG KONG LAW JOURNAL 188-199

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Unfortunately, however, the most recent bill, gazetted in 2001, retains this position. In late 2001 it appeared that a possible compromise was in the offing pursuant to which instead of a company having to pay off its workers in full in advance (or to set up a trust account), a limit or cap would be put on the amount that would have to be set aside by the company before it could go into provisional supervision. This limit would be calculated by reference to the amounts currently payable by the Protection of Wages on Insolvency Fund where a company goes into compulsory liquidation. However it seems that this compromise might prove to be too little, too late, and at this stage most pundits are predicting that the bill will not be enacted.

II. Institutional developments

• The judiciary

Hong Kong has a well-developed institutional framework for administering insolvency cases, based on an English model. There is not a separate insolvency court system. Rather, the Court of First Instance, Hong Kong’s highest trial court and part of the Hong Kong High Court, has jurisdiction over corporate liquidations and reorganizations. Twenty-four judges sit in the Court of First Instance and one judge hears company law cases and deals with contested winding-up petitions and other corporate insolvency matters. This judge will also deal with matters relating to provisional supervision, if the new procedures are enacted. Unopposed winding-up petitions are dealt with by the Registrar of the High Court in open court.

Article 85 of the Basic Law provides for the independence of the judiciary. Unlike in some other Asian jurisdictions, in Hong Kong the government does not interfere in the handling and administration of insolvency cases. There is confidence among insolvency practitioners in the independence and integrity of the judicial system and in the standards of performance of the judiciary. Article 92 of the Basic Law provides that judges shall be chosen on the basis of their judicial and administrative qualities and may be recruited from outside Hong Kong. Article 88 provides that judges are to be appointed by the Chief Executive on the recommendation of an independent commission. In practice, most judges come from the Hong Kong Bar.

• The professionals

There is a large group of insolvency practitioners (lawyers, accountants, and others) in Hong Kong. As Hong Kong’s system is based on the English model, accountants play the central role in the process. There is no formal registration or certification procedure for insolvency practitioners. However, the Official Receiver’s Office sets requirements for insolvency practitioners who wish to be appointed as liquidator. For example, to be able to serve as a Panel A liquidator in a compulsory liquidation case in which the assets exceed HK$200,000, an insolvency practitioner must show that she has undertaken at least 600 hours of insolvency work on non-related insolvent liquidations during the previous three years.

The Hong Kong Institute of Certified Public Accountants (HKICPA) (formerly the Hong Kong Society of Accountants or HKSA) has established an Insolvency Interest Group that is open to accountants, lawyers, and other insolvency practitioners. The HKICPA also runs three insolvency training courses, including a Diploma Course in Insolvency (soon entering its 4th year), which is recognized by the Official Receiver’s Office. Successful completion of the Diploma Course counts as the equivalent of 50 hours toward the 600-hour requirement under the Panel A scheme.

The Official Receiver’s Office monitors the conduct of private sector insolvency practitioners in compulsory liquidations and, where necessary, takes action against those practitioners who are negligent or fraudulent in their case work, including the commencement of disqualification proceedings. The statutory framework for the remuneration of insolvency professionals is set out in the Companies Ordinance and the Companies (Winding Up) Rules (CWUR). Section 196 of the Companies Ordinance provides that where a person other than the Official Receiver has been appointed liquidator, his remuneration shall be by way of percentage or otherwise as determined (a) where there is a committee of inspection, by agreement between the liquidator and the committee of inspection or (b) where there is no committee or where the liquidator and committee are unable to agree, by the court. CWUR rule, 146(2) provides that where there is no committee, the liquidator’s remuneration shall be fixed by the scale of fees and percentages for the time being payable on realizations and distributions by the Official Receiver
as liquidator. Where the Official Receiver is of the opinion that the remuneration of a liquidator should be reviewed, he may apply to the court and the court may make an order confirming, increasing or reducing the remuneration of the liquidator. (CO, s 196(2A). The Official Receiver has approved standard hourly rates for Panel A liquidators, in consultation with the Hong Kong Society of Accountants.

The issue of the compensation of insolvency professionals in Hong Kong was sparked by a judgment in the liquidation proceedings arising from the collapse of Peregrine – *Re Peregrine Investments Holdings Ltd & Ors* [1998] 3 HKC 1. The case involved a request by the provisional liquidators for payment of their fees and recoupment or reimbursement for professional fees incurred by them out of the assets of the companies in liquidation. The sums sought were substantial – HK$76 million for the 63 days between the commencement of the provisional supervision and the making of the winding-up orders. In the court’s view, the critical issue was whether the provisional liquidators had discharged the burden of showing that the fees they sought were justified. Among the factors noted by the court were the following (*ibid*, p 15):

- whether the provisional liquidators had sufficiently explained the nature of each task undertaken;
- whether these explanations were properly linked to the time spent on the task;
- whether a reasonably prudent man would have spent his own money on what the provisional liquidators did;
- whether the provisional liquidators had produced contemporaneous time records of what they did and why they did it, as well as of all items of expenditure and of services rendered, how they were calculated, and how they were justified;
- whether the fees for any item of work should be disallowed as being unnecessarily incurred; and
- whether the fees for any item of work should be disallowed as being incurred in the breach of duties.

This case led HK accountants and solicitors to review their internal billing and record keeping practices.

### The regulators

The Hong Kong Monetary Authority (HKMA) is effectively a combined Central Bank and Regulatory Commission, reporting to Hong Kong’s Financial Secretary. Several boards (ie, the Exchange Fund Advisory Committee, the Banking Advisory Committee, and the Deposit Taking Company Advisory Committee) oversee the major functions of the HKMA. While the HKMA is superficially analogous to a Ministry of Finance unit, the operational autonomy of the HKMA is statutorily guaranteed by the Exchange Fund and Banking Ordinances. Operational autonomy was further clarified in June 2003 by a public exchange of letters that details the delegation of statutory powers from the Financial Secretary to the HKMA.

The total staff of the HKMA is approximately 600. Even post-handover, Hong Kong continues to open senior regulatory positions to non-local candidates, thereby tapping a global talent pool. The Hong Kong civil service is among world’s highest paid, and the remuneration of regulators has been adjusted further to be competitive with the local highly-compensated financial sector. Pay for HKMA staff is reviewed annually by the Financial Secretary, taking into account the findings of independent consultants on pay trends and pay levels in the financial sector. Staff members are entitled to an annual bonus based on individual performance.

In bank regulation, the HKMA operates with a high degree of transparency, exemplified by the detailed and bilingual guidelines on risk management published online; Hong Kong’s role as a regional centre of financial journalism may have positive effects as well.

Since 2002, the HKMA has implemented a training program of vertical and horizontal training, encompassing topics including risk-based supervision, the New Capital Accord, stress testing, money laundering, deposit protection, credit reference agency and securities activities. In 2003, an average of 6.4 training days per staff was provided.

### Status of other institutions, such as AMCs
AMCs and other government-sponsored financial or corporate work-out institutions have not been necessary in Hong Kong. (Some may assert that the support provided to the Hong Kong stock market by investment into the Tracker Fund by the Exchange Fund several years ago might have served some of the same purpose).

III. Current practices in various areas

• Efficiency of secured lending procedures and unsecured credit

Hong Kong has an effective secured-lending regime with fixed and floating charges based on the English model, although floating charges are less frequently used in Hong Kong than in England. Banks enforce their charges through the appointment of a receiver (fixed charge) or a receiver and manager (floating charge).

• Recourse to liquidation

A record 1,451 compulsory winding-up petitions were filed in 2003. The rate has slowed down a little with 1,048 petitions having been filed in the first ten months of 2004. (Winding-up orders were made in 1,248 cases in 2003 and in 927 cases in the first ten months of 2004.) (The statistics are from the Official Receiver’s website at http://www.info.gov.hk/oro/statistics/statistics.htm.) However, these numbers would have been much higher if creditors had resorted to corporate insolvency at the rates seen in many counties overseas. In Hong Kong, creditors generally, and banks in particular, are slow to petition for liquidation, it is common for banks that have security in the form of real property that is underwater to wait for market recovery rather than to resort to winding-up proceedings.

The threat of commencing liquidation proceedings is a disciplining mechanism in Hong Kong; until recently, the filing of a winding-up petition was the death knell for a company.

• Recourse to reorganisation procedures/out-of-court workouts

The formal corporate rescue mechanism under section 166 of the Companies Ordinance is rarely used. As noted above, there have been some recent cases in which provisional liquidation has been used to facilitate reorganisation. The majority of companies in Hong Kong that resort to reorganisation are restructured out of court. The government does not keep any statistics on the utilization of The Hong Kong Approach to Corporate Difficulties or on out-of-court workouts generally. Furthermore, data from the private sector is hard to come by, as most companies prefer to keep their “reorganisation” confidential. Anecdotal evidence, however, suggests that the annual number of successful out-of-court corporate restructurings of Hong Kong companies is in the low 100s, while the number of cases involving formal or informal rescheduling or refinancing of debt is in the low 1000s.

B. CURRENT RISK ASSESSMENT AND MANAGEMENT SYSTEMS AND POLICIES

I. Risk Assessment and Management Systems

• Sources of major credit problems

The chronic credit concern in Hong Kong for decades has been exposure to the real estate sector – aggregating exposures via residential and commercial mortgages, loans to property developers and projects, and less direct exposure via loans to companies heavily engaged in property development and/or investment. Historically, credit problems arose cyclically from over-lending to developers, with owner-occupied residential properties enjoying very low default rates. However, in recent years Hong Kong has not experienced a banking crisis due to this concentration of credit, though bank credit is highly concentrated in residential mortgages and real estate development, as the table below displays.

• Prudential norms, role of financial sector authorities, & supervisory information needs
The HKMA has taken an aggressive posture on compliance with the Bank for International Settlements. For example, the internationally accepted capital adequacy framework proposed by the Basle Committee on Banking Supervision in 1988 has been applied in Hong Kong since the end of 1989. Locally incorporated institutions report their capital adequacy ratios in accordance with the Basle I definition. The consolidated capital adequacy ratio for locally incorporated institutions has remained in the high-teens over the past five years – well in excess of the minimum international standard of 8% set by the Basle Committee.

In a presentation given in September 2004 to the Global Association of Risk Professionals–Asia Pacific Convention, the HKMA’s Executive Director, Banking Policy, demonstrated Hong Kong’s commitment to apply Basle II, pointing out, inter alia, that “Hong Kong is one of the first jurisdictions to publish detailed implementation plans for Basle II” and that “we will allow institutions to choose between standardised approach, foundation IRB and advanced IRB for credit risk, and between basic indicator approach and standardised approach (not AMA) for operational risk; we will also allow smaller institutions to choose a “basic” approach”.

With encouragement from the HKMA, banks are moving to greater granularity in internal risk rating systems; internally-used loan classification systems are generally increasing to 8-12, though still mapped to a standard central bank 5-category system in use since 1994.

Value-at-Risk (VaR) measurement of market risk is almost universally used by banks active in Hong Kong, and VaR figures are regularly disclosed in footnotes to accounts. More recently, some larger banks are extending VaR methodology to credit portfolios.

As Hong Kong has been relatively early in articulating its posture on Basle II compliance for its banks, the consideration of software system upgrades (and aggressive marketing by their providers) has also received an early start.

- **Existence and effectiveness of specific structures**

Banks adhere to HKMA credit principles guidelines re separation of risk management and marketing; separation of credit risk and branch management; independent internal audit function; and convergence of credit origination, credit risk management, and credit inspection at or close to Board level.

Weaknesses have been revealed in banks’ credit card risk management procedures.

- **Disclosure requirements and practices**

The standard of financial disclosure in Hong Kong has been brought substantially in line with that of other leading financial centres following adoption in 1994 by Authorised Institutions (AI) (see text box below) of the Best Practice Guide on Financial Disclosure issued by the HKMA. In addition to annual disclosure standards for locally incorporated authorized institutions, the HKMA has also issued guidance in respect of interim financial disclosure by locally incorporated institutions and half-yearly financial disclosure by overseas incorporated institutions. In 2001, the three sets of financial disclosure standards were recast into modules of the HKMA’s consolidated Supervisory Policy Manual.

Annual reports are not generally released; instead, companies publish their results on one or two pages in local newspapers. In contrast to their counterparts in many Western countries, Hong Kong companies are usually slower to voluntarily release negative information during the middle of reporting periods and less likely to comply with filing deadlines as set out in the companies legislation.

- **Extent to which the practices take into consideration new financial instruments: their relevance in addressing NPAs in the country; and adequacy of risk management schemes to evaluate the risks stemming from new financial instruments**
In June 2001, the HKMA issued a statutory guideline under the Banking Ordinance, section 16(10), superseding its Circular “Supervisory Approach to Credit Derivatives” of November 1999. The Guideline sets out the HKMA’s supervisory approach to credit derivative instruments, particularly in relation to capital requirements and treatment for large exposures, and covers, *inter alia*, Use of Credit Derivatives, Types of Credit Derivatives, Credit Derivatives Policy, Risk Management, and Information Requirements. In the Guideline, the HKMA provides for review and approval on a case-by-case basis of AI’s internal models for calculating capital charges related to credit derivatives or, alternatively, for compliance with the Basel standardised approach.

- **Analyse measures under consideration by government, regulator, banks and financial institutions to assess and manage risk**

After deliberations spanning several years, Hong Kong’s legislature approved the Deposit Protection Scheme Ordinance, of which section 3 establishes the Deposit Protection Board. As per the HKMA press release of 30 June 2004: “It is envisaged that the Board will be able to start collecting contributions and providing deposit protection in 2006."

II. Credit Information Systems

- **quality of the legal framework for information sharing and dissemination, credit scoring and rating**

Although the major international credit bureaus and rating agencies have operated in Hong Kong for many years, and banks have cooperated according to the traditional manner in sharing credit information, the government has long recognised a need for more comprehensive and widely available credit information.

- **credit information collecting, collating and sharing systems**

In 2001, the Legislative Council passed a motion to establish a Commercial Credit Reference Agency (CCRA) in Hong Kong to gather and collate information about the indebtedness of commercial enterprises and make the information available to lending institutions. Since then, the Industry Working Group and its advisors have finalised the operational details, and the HKMA has developed and finalised the statutory guideline governing the sharing and use of credit data. The guideline was circulated to all AIs in June 2004, and the CCRA is expected to be fully operational by the end of this year.

III. Credit risk transfer (CRT) and new financial instruments

CRT is assumed herein to refer to: (i) asset management companies and “bad bank” structures in weak systems; (ii) securitisation of loans in both healthy and weak systems; and (iii) risk management tools such as credit insurance and credit derivatives.

- **Definitions and analysis of existing credit risk instruments (single name, portfolio, funded – eg sales of loans, etc. or unfunded – eg insurance contracts, direct risk transfer or through special purpose vehicles);**

In Hong Kong a spectrum of instruments for credit risk transfer on a commercial basis is available, including credit insurance, credit risk swaps and a debt-securitisation market. Not applicable are government-sponsored solutions for transferring risk from banks.

- **CRT markets: drivers of development (supply-banks and demand-managed funds); and the role of policy**

The primary drivers of development likely are intermediaries such as international investment banks, of which Hong Kong has a concentrated pool given its role as a financial centre. Local government policy has been oriented both towards regulation of the local market, and protection and development of Hong Kong’s regional and global role.
The market for loan securitisation in Hong Kong has developed extensively since the early 1990s, mainly as a means for banks to adjust their mortgage portfolios rather than to effect NPA reduction. The government has encouraged development of the loan securitisation market through the uncharacteristic creation of a government financial institution, the Hong Kong Mortgage Corporation (HKMC), a public limited company incorporated under the Companies Ordinance and wholly owned by the government. The HKMC was incorporated in March 1997 with a view to developing Hong Kong’s secondary mortgage market. Its business is being developed in two phases: (1) purchasing mortgage loans for its own portfolio, funded largely through the issuance of unsecured debt securities; and (2) securitising mortgages into mortgage-backed securities which are offered for sale to investors.

- **Market institutions and concentration of markets in a few institutions**

The regional economic situation of the late 1990s did not affect Hong Kong to the extent that a government-sponsored institution for CRT, or emergency involvement by state-owned or state-related banks was required. Therefore, there is no particular concentration of CRT in specific institutions. The volume of institutional CRT via debt trading and securitisation has grown, and its market encompasses a broad spectrum of lending institutions, international investment banks and specialised investment funds.

- **Role of credit monitoring, credit insurance and rating agencies**

The Hong Kong government has not backed the creation of a credit insurance institution. In recent years international insurance companies and brokers have become more active in providing commercial credit insurance. In certain instances, such as in proposed guidelines for compliance with Basle II, regulators have made specific provision for adjustment of lending limits and capital provisioning for credits which are wholly or partially insured by a third-party. The major international rating agencies are active in Hong Kong, with the territory’s high debt rating leading to the enjoyment of investment-grade or near-investment grade rating by many local corporate debt instruments.

**Conclusions and Recommendations**

**Sum up, analysis and comment on the appropriateness and sufficiency of the steps, measures, reforms and implementation in the areas covered in the paper.**

Although risk assessment and management systems in Hong Kong could, of course, be improved, they appear to be adequate at present. Hong Kong’s credit information systems are in the process of being expanded to enable more information to be made available to lending institutions. CRT in the form of government-sponsored AMCs is not necessary in Hong Kong. CRT in the form of loan securitisation is expanding as the market for loan securitisation continues to grow.

**Provide specific recommendations and suggestions on policy and legislative changes/reforms that are required to strengthen the creditor right, insolvency and credit management systems in your country.**

Hong Kong does not have a systemic insolvency problem at present and did not have such a problem even at the height of the Asian financial crisis. The current insolvency system is sound. Credit risk improvements would be beneficial for improving the performance and efficiency of Hong Kong banking institutions. Such improvements might well bring down the rate of insolvency in Hong Kong, but this would be an additional benefit, not the main reason for the reforms. As noted above, the main legislative need in Hong Kong – which is independent of credit risk management – is for the enactment of a formal corporate rescue procedure.

**Text Box on Non-Performing Assets (NPAs)**

- **Examine the definition and classification, Non-Performing Assets status (statistics of value and estimates of NPA as a percentage to total loans for a 5-year period and present year)**

The HKMA uses a 5-category system:
### Discuss the relevance of insolvency procedures and other procedures (work-outs, debt write-offs, direct sales to national and foreign investors) to address NPAs

As can be seen from the above chart, NPAs are not a major problem in Hong Kong. Moreover, data for the last five years shows an increase, rather than a decrease in asset quality, as Hong Kong has recovered and emerged from the Asian financial crisis. As noted above, Hong Kong never experienced the systemic NPA problems as did other Asian jurisdictions. Although the number of insolvencies did increase during the Asian financial crisis, the magnitude never reached a critical level. The current liquidation, reorganization, and write-off procedures seem adequate to handle the level of NPAs. What Hong Kong lacks is an effective, efficient formal work-out procedure, which would supplement the HKMA Guidelines and offer a weapon against holdout creditors in out-of-court workouts.

### Analyse the factors that contribute to NPAs, their impact on banks and economy etc.

One of the problems in Hong Kong affecting the NPAs for banks has been the negative equity in residential mortgages. However, the residential market conditions have been improving – in some sectors returning to, and even exceeding, 1997 levels.

### Text Box or Table on the Financial Sector

#### types and number of banks and financial institutions;

Hong Kong has a three-tier system of deposit-taking institutions, namely, Licensed Banks, Restricted License Banks (RLBs) and Deposit-Taking Companies (DTCs), collectively known as Authorised Institutions (AIs). Hong Kong’s 214 AIs operate a total of 1,299 local branches. A total of 187 AIs are beneficially owned by interests from 31 countries.

1. **Licensed Banks:**
   - Total number of Licensed Banks: 134
2. **Registered License Banks (RLBs):**
   - May not conduct “banking business” but generally are involved in merchant banking and capital market operations;
   - May accept deposits in amounts of HK$500,000 and above;
   - Total number of RLBs: 43
3. **Deposit Taking Companies (DTCs):**
   - Generally involved in consumer finance, trade finance, securities business or other specialized activities;
   - May accept deposits in amounts of HK$100,000 and above, with original maturity of a minimum of 3 months;
   - Total number of DTCs: 37
4. **HKMA authorises two additional categories of financial institution:**
   - Local Representative Offices (LROs), of which there are 89;
   - Approved Money Brokers, of which there are 12.

### financial health of major lenders and potential sources of systemic risk
1. Loan quality breakdown (30 June 2004 as reported by the HKMA):
   - Pass loans: 91.4%
   - Special mention loans: 5.6%
   - Classified loans (Substandard + Doubtful + Loss) 3.0%
2. Loan quality improved steadily since a recent historical low in 1Q 1999 (see table above):
   - 1Q 1999 = Pass: 80.2%; Special mention: 9.7%; Classified: 10.1%
3. Capital position of AI’s (31 August 2004 as reported by the HKMA):
   - Capital + Reserves + Other Liabilities / Total Assets = 12.3%
4. Capital position improved steadily since 4Q 1997:
   - Capital + Reserves + Other Liabilities / Total Assets = 8.2%
5. Risks related to local activities:
   - Segmental concentrations in residential property, property development and financial services.
6. Risks related to international activities:
   - Activities of foreign bank branches and offices;
   - Derivatives portfolios and trading activities of AIs;
   - Lending to enterprises whose ultimate parents are domiciled in PRC;
   - Risk of sudden change in fixed exchange rates of HKD and CNY.

- **prudential supervision and regulatory capacity**

The HKMA conducts on-site, off-site and third-party examinations of AIs to supplement its policy of “continuous supervision”. HKMA uses a “CAMEL” scoring system (Capital adequacy, Asset quality, Management, Earnings and Liquidity) for AIs and considers applications to become controllers, directors, chief executives and alternate chief executive officers of AIs. In 2003, the HKMA conducted 247 on-site examinations of AIs’ operations, including 76 risk-focused, 9 treasury, and 18 securities examinations. The on-site examinations also included 21 focused examinations of specific components of credit portfolios and 10 special examinations of AIs’ lending policies and practices. On-site examinations were higher in 2002, as precautionary measures to reduce physical interaction were taken by AIs and by HKMA during the second quarter of 2003 due to the SARS outbreak. The HKMA’s specialized examination teams for electronic banking conducted 28 e-banking and IT related examinations in 2003.

- **financial institutions suspended or closed recently in your country**

None.

- **ownership structures of banks – if majority privately owned or not**

The large majority of bank assets are held by publicly-listed banks with diverse share ownership. An important local exception is BOC Hong Kong (Holdings) Ltd, majority-owned by its ultimate parent, the Bank of China. There is no state development-bank sector.

- **ownership and control of banks and firms by the same shareholder, if relevant**

This is not relevant since the shake-out of family-controlled banks in the early 1980s.

- **state bail-outs of banks, state subsidies to state banks and if relevant, interference in management of banks**

This is not a current issue; in previous decades, the government used suasion to encourage stronger banks to acquire weaker local banks.

- **size, types and volume of credit**
Aggregate Balance Sheet of AIs:

<table>
<thead>
<tr>
<th>Total Loans and Advances</th>
<th>Amount</th>
<th>% of total AIs</th>
</tr>
</thead>
<tbody>
<tr>
<td>For use in Hong Kong</td>
<td>1,626,512</td>
<td>94.9%</td>
</tr>
<tr>
<td>For use outside Hong Kong</td>
<td>183,229</td>
<td>94.8%</td>
</tr>
<tr>
<td>Unknown</td>
<td>19,920</td>
<td>93.4%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>2,062,534</td>
<td>97.9%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Loans and Advances by Business Sector</th>
<th>Amount</th>
<th>% of total AIs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Professional and Private Individuals (for purchase of residential property)</td>
<td>746,544</td>
<td>43.2%</td>
</tr>
<tr>
<td>Building and Construction, Property Development and Investment</td>
<td>360,824</td>
<td>20.9%</td>
</tr>
<tr>
<td>Financial Concerns</td>
<td>156,184</td>
<td>9.0%</td>
</tr>
<tr>
<td>Transport and Equipment</td>
<td>112,919</td>
<td>6.5%</td>
</tr>
<tr>
<td>Wholesale and Retail Trade</td>
<td>98,450</td>
<td>5.7%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>91,953</td>
<td>5.3%</td>
</tr>
<tr>
<td>Electricity, Gas and Telecommunications</td>
<td>43,038</td>
<td>2.5%</td>
</tr>
<tr>
<td>Other</td>
<td>117,578</td>
<td>6.8%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>1,727,490</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

- **types of collateral, directed lending and their percentage**

As the above table displays, real estate assets, in particular residential mortgages, are the dominant type of collateral. Directed lending to priority sectors has not been a feature of Hong Kong’s administration either during the colonial or post-colonial periods.

- **risk management capacity**

Risk Management Capacity can be defined in different ways, but by most measurements, Hong Kong would rank high. For example, in addition to the issues of capital adequacy, legal framework and regulatory effectiveness discussed earlier, Hong Kong can include among its strengths the availability of financial instruments used for risk management. The Bank for International Settlements triennial survey on turnover of foreign exchange and derivatives, released in September 2004, showed Hong Kong advancing one place from 2001 to rank sixth in the global foreign exchange market, and seventh in the foreign exchange and over-the-counter derivatives market. Average daily net turnover of over-the-counter derivatives (both foreign exchange and interest rate derivatives) increased by 2.6 times to US$14.9 billion.

- **financial market characteristics and role in risk management**

The major characteristics of Hong Kong’s financial markets, which affect the territory’s risk management capability are:

- Hong Kong’s position as a major international financial centre
- Transparency of the financial markets, both as regards financial institutions and regulatory policies
- Consciousness of best international practices in risk management
- Concentration of banking (and legal and audit) talent locally
Suggested additional materials:

- Hong Kong Monetary Authority: http://www.info.gov.hk/hkma/.