

SM/09/206  
Correction 1

CONFIDENTIAL

July 14, 2011

To: Members of the Executive Board

From: The Secretary

Subject: **Macao Special Administrative Region of the People's Republic of China—Assessment of Financial Sector Supervision and Regulation**

The Secretary's note of transmittal has been amended to reflect the updated publication intention to read as follows:

The Secretary's Department has received a communication from the authorities of Macao SAR indicating that they now wish to publish the paper on the assessment of financial sector supervision and regulation for Macao SAR (SM/09/206, 7/27/09).

The attached corrections to SM/09/206 (7/27/09) have been provided by the staff:

**Factual Errors Not Affecting the Presentation of Staff's Analysis or Views**

**Page 4, Executive Summary, line 2:** for "98" read "94"

**Page 7, footnote 6:** for "Mainland China" read "the Chinese mainland"

**Page 8, para. 5 lines 5, 12 and 13:** for "Mainland China" read "the Chinese mainland"  
**para. 6, lines 1, 2, 4, 5, 7 and 8:** for "Mainland China" read "the Chinese mainland"

**Page 9, para. 8, line 7:** for "Mainland China" read "the Chinese mainland"  
**footnote 10:** for "Mainland China" read "the Chinese mainland"

**Page 11, para. 13, line 2:** for "Mainland China" read "the Chinese mainland"

**Page 12, para. 13, line 5:** for "Mainland China" read "the Chinese mainland"

**Page 19, para. 30, lines 3 and 4:** for "Mainland China" read "the Chinese mainland"

**Page 10, para. 9, line 8:** for "16" read "13"

**Page 12, para. 15, lines 4-6:**

for “(mainly retail customers resided in Mainland China or HKSAR offshore banks, and customers resided in Europe).

read “(mainly retail customers residing in the Chinese mainland or HKSAR, and mainly customers residing in the EU for offshore banks).

**Page 19, para. 30, line 6:** for “Semi-annual” read “Annual or semi-annual”

**Page 20, para. 36, line 5:** for “1980s” read “1990s”

**Page 26, para. 7, line 13, after “6”:** insert “money”

### **Typographical Errors**

**Page 8, para. 5, line 12:** for “form” read “from”

**Page 25, para. 3, line 2, after “be”:** insert “in”

### **Evident Ambiguity**

**Page 1, Bullet 4, lines 4 and 5:**

for “Shortcomings, such as insufficient customer due diligence obligations for financial institutions, still needed to be addressed.”

read “Shortcomings, notably in the area of customer due diligence obligations for financial institutions, still needed to be addressed.”

**Page 7, para. 4, lines 1 and 2:**

for “Macao, a former dependent territory under Portuguese administration, became a Special Administrative Region of the People’s Republic of China (PRC)<sup>5</sup> at the end of 1999.”

read ““Macao<sup>5</sup> became a Special Administrative Region of the People’s Republic of China (PRC)<sup>6</sup> at the end of 1999.”

**Page 7, insert footnote 5:**

read “Prior to December 20, 1999, the territory, under Portuguese administration, was referred to as Macau.” Subsequent footnotes renumbered.

Questions may be referred to Ms. Gobat, MCM (ext. 39332).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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SM/09/206  
Corrected: 7/13/11

CONFIDENTIAL

July 27, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Macao Special Administrative Region of the People's Republic of China—Assessment of Financial Sector Supervision and Regulation**

Attached for the **information** of the Executive Directors is a paper on the assessment of financial sector supervision and regulation for Macao SAR. ~~At the time of circulation of this paper to the Board, the Secretary's Department has received communication from the authorities of Macao SAR indicating that they do not consent to the Fund's publication of this paper.~~ The Secretary's Department has received a communication from the authorities of Macao SAR indicating that they now wish to publish the paper on the assessment of financial sector supervision and regulation for Macao SAR (SM/09/206, 7/27/09).

Questions may be referred to Ms. Ong, MCM (ext. 34842).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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INTERNATIONAL MONETARY FUND

MACAO SPECIAL ADMINISTRATIVE REGION OF THE PEOPLE'S REPUBLIC OF CHINA

**ASSESSMENT OF FINANCIAL SECTOR SUPERVISION AND REGULATION**

Prepared by Monetary and Capital Markets Department

Approved by Hervé Ferhani and James Gordon

July 23, 2009

This report is based on the assessment work undertaken during a visit to Macao Special Administrative Region (Macao SAR) between July 15-28, 2008. The assessment is an update of the 2002 assessment, and is based on the Module 2 assessment framework for offshore financial centers (OFC). The team comprised Ms. Jeanne Gobat (head; IMF), Mr. Michael Deasy (banking supervision expert), Mr. Jose Tuya (banking supervision expert), and Mr. Henning Göbel (insurance supervision expert). The key findings were as follows:

- **Banks generally enjoy robust capitalization and adequate profitability.** To date, there has been little direct impact on local banks from the global financial crisis. Most banks did not report significant exposures to the most affected asset classes and remained profitable in 2008. Credit risk poses the main challenge. Pressures on banks' earnings and capital could emerge from a substantial correction in the property market and/or an end or sharp deceleration of the casino boom. Counterparty risk is also high, given that banks place the bulk of their surplus liquidity with parent banks abroad.
- **The financial supervisory framework has strengthened, with several gaps identified in the 2002 assessment addressed.** Overall, the assessment team found there to be a high level of compliance with Basel Core Principles. Further, the disclosure of financial information has been further enhanced, including through participation in the IMF Information Framework Initiative. Going forward, the conduct of supervision will need to evolve from one of compliance towards a more risk focused approach. This would also be in line with the risk focused regulations and guidelines issued recently.
- **Notwithstanding, legal shortcomings in the operational independence of the Monetary Authority of Macao (AMCM) as financial regulator have yet to be addressed.** The AMCM lacks adequate legal independence and final decision making authority over critical supervisory issues.
- **The anti-money laundering and combating the financing of terrorism (AML/CFT) framework of Macao SAR was evaluated against the Financial Action Task Force (FATF) 40+9 Recommendations in December 2006.** While the evaluators found that the overall framework was sound, it lacked the necessary level of detail to comply fully with the standard. Shortcomings, [notably in the area of such as insufficient](#) customer due diligence obligations for financial institutions, still needed to be addressed.

The authorities were in broad agreement with the findings of the assessment.

Jeanne Gobat is the main author of this AFSSR with contributions from the rest of the team.

*The AFSSR is a summary report on implementation of the indicated financial sector regulatory standards. It has been developed to help jurisdictions identify and remedy weaknesses in financial sector supervision and regulation. The reviews do not directly assess risks, such as those associated with asset quality, markets, or fraud, which could affect the soundness of financial systems or individual institutions.*

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## GLOSSARY

AFSSR	Assessment of Financial Sector Supervision and Regulation
AMCM	Monetary Authority of Macao
AML/CFT	Anti-money laundering and combating the financing of terrorism
APG	Asia Pacific Group
BOC	Bank of China
BCP	Basel Core Principles
BIS	Bank of International Settlements
CBA	Currency Board Arrangement
CEPA	Closer Economic Partnership Agreement
BSD	Banking Supervision Department
FATF	Financial Action Task Force
FSA	Financial System Act
FX	Foreign Exchange
GDP	Gross Domestic Product
HKSAR	Hong Kong SAR
HHI	Herfindhal Hirshman Index
HK	Hong Kong
HKMA	Hong Kong Monetary Authority
HK\$	Hong Kong Dollar
IAS	International Accounting Standards
ICP	Insurance Core Principles
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
MAS	Monetary Authority of Singapore
ME	Mutual Evaluation
MOP	Pataca
MOUs	Memorandum of Understanding
MSAR	Macao SAR
NPL	Non Performing Loans
OFC	Offshore Financial Center
OGBS	Offshore Group of Banking Supervisors
PCA	Prompt Corrective Action
POC	Province of China
PRC	People's Republic of China
ROSC	Report on the Observance of Standards and Codes
SAR	Special Administrative Region
US\$	U.S. Dollar

## EXECUTIVE SUMMARY

**The financial sector of Macao SAR is large, and bank dominated.** Total financial sector assets amounted to 307 percent of GDP in 2008, with banking assets accounting for ~~94~~<sup>98</sup> percent of the total. Local banking operations benefit from the financial and risk management support of their parent banks and the AMCM takes this into account in its role as host supervisor in addition to collaboration with home regulators.

**Since the 2002 OFC assessment, Macao SAR has made important progress in strengthening the regulatory and supervisory framework governing the financial sector.** The AMCM has addressed a number of gaps identified in the 2002 assessment and stepped up its efforts to implement international bank supervisory guidance, including issuing risk based regulatory and supervisory guidelines, implementing the market risk amendment to the capital framework, enhancing disclosure of financial information, and addressing staffing shortages.

**Notwithstanding, the absence of operational independence of the AMCM in the law undermines the supervisory framework .** The lack of such independence can lead to delaying regulatory action and operational supervisory decisions. The current law also gives the chief executive of Macao SAR final decision making authority over critical banking prudential issues. The same issue applies to insurance supervision, where the legal authority over licensing approval, regulation of tariffs and sanctions rests with the chief executive of Macao SAR.

**The AMCM should be granted independence to empower it to safeguard the soundness and stability of the financial system.** Aligning Macao SAR's supervisory framework with international best practices requires providing operational independence from the government of Macao SAR and the legal authority and final enforcement power over financial regulatory decisions to the AMCM. In addition, this includes spelling out the procedures for appointment and dismissal of AMCM's chairman in the law. The term of the chairman should also be extended to beyond the current two years.

**Going forward, the conduct of supervision will need to evolve from a more compliance approach toward a risk-based supervisory approach.** There should be far greater emphasis on the comprehensive assessment of the risk profile of individual banks and financial systemic risk. As part of this, the AMCM should in its offsite reviews incorporate market analysis of parent banks' financial condition and input from home country supervisors. Resources should be proportionately allocated to those institutions from home countries that pose higher economic and systemic risk or where home supervision or parent company financial support is weak. The offsite analytical process can be enhanced by deepening the analysis of bank-specific trends and undertaking more systemic analysis of the banking sector. Stress testing should be used as a supervisory tool to examine the resilience of the system and individual institutions to specific shocks. Finally, it is recommended that the development of an onsite manual be completed.

**The supervisory framework of the insurance sector needs to be strengthened.** High priority needs to be on prioritizing the supervisory approach. Fewer resources should be devoted to noncore functions such as the management of guaranteed funds and customer complaints and



## I. INTRODUCTION

1. **At the invitation of the government of Macao SAR (Special Administrative Region of the People's Republic of China), an update assessment of the OFC was carried out from July 15–July 28, 2008.** The assessment for Macao SAR was conducted under the OFC program Module 2.<sup>1</sup>

2. **The IMF's Module 2 assessment of Macao SAR took place at end 2001, with the final report issued in August 2002.**<sup>2</sup> At that time, the mission concluded that the Macao SAR had in place a comprehensive supervisory structure and practices that supported an effective and well regulated financial environment. Staff advised the authorities to further strengthen the supervisory architecture by enhancing the regulatory independence of the AMCM;<sup>3</sup> incorporating market risk into the Basel capital adequacy calculation; issuing guidelines on country and concentration risks; increasing supervisory resources; developing supervision manuals and handbooks for banking and insurance; providing for greater information sharing among regulatory bodies, and strengthening the AML/CFT regime. The main recommendations and the current status of implementation, as reported by the authorities, are summarized in Appendix I.

3. **The assessment focused on developments in the supervisory and regulatory framework since the 2002 Module 2 OFC assessment.** Key tasks included: (i) assessing implementation of the 2002 recommendations; (ii) assessing compliance with the Basel Core Principles for Effective Banking Supervision (BCP) against the revised 2006 principles; (iii) updating the 2002 assessment of the insurance sector based on the principles of the International Association of Insurance Supervisors (IAIS) of insurance supervision and review the performance of the sector.

## II. BACKGROUND

### A. Macro Setting<sup>4</sup>

4. **Macao<sup>5</sup>, ~~a former dependant territory under Portuguese administration~~, became a Special Administrative Region (SAR) of the People's Republic of China (PRC)<sup>6</sup> at the end of 1999.** The Basic Law provides that Macao SAR preserves its social and economic system for 50 years, within the framework of the Chinese formula for “one country, two systems.”

<sup>1</sup> The Board agreed to the integration of the OFC program into the FSAP but permitted a transition period during which all scheduled OFC assessments could be conducted under the OFC Module 2 program (Buff/08/78).

<sup>2</sup> Macao SAR: Assessment of the Regulation and Supervision of the Financial Sector (August 2002).

<sup>3</sup> AMCM is the Portuguese abbreviation of the Monetary Authority of Macau and is widely used. Macao and Macau are used interchangeably.

<sup>4</sup> The last Article IV consultation with Macao was carried out in 1998. As a result, Macao SAR's macro-economic framework is only periodically reviewed.

<sup>5</sup> Prior to December 20, 1999, the territory, under Portuguese administration, was referred to as Macau.

<sup>6</sup> People's Republic of China is also referred as Mainland China the Chinese mainland in this document.

5. **Since 2003, Macao SAR (MSAR)<sup>7</sup> has benefited from a gaming-driven economic boom.** In the course of less than five years, Macao has transformed itself into the top global destination for gaming/casino related activities. It has now more casinos, visitors, and gaming turnover than Las Vegas. Visitor arrivals reached a record high of 27 million in 2007 (compared to a local population of about 500,000), with ~~Mainland China~~ the Chinese mainland visitors accounting for about half of arrivals. MSAR's per capita GDP, which was about half the level of Hong Kong SAR (HKSAR) in 2001, now at US\$ 36,357 exceeds that of its neighbor city. Real GDP growth averaged about 20 percent over the past five years, supported by a threefold increase in tourism and gaming related spending and revenue and a boom in the construction of hotels, casinos, convention and shopping centers, and residential property developments as well as further reclaiming of land. Foreign capital financed most of this construction and property market boom, with financing mainly coming ~~from~~ from HKSAR, ~~Mainland China~~ the Chinese mainland, and the United States.

6. **Structural reforms and enhanced economic integration with ~~Mainland China~~ the Chinese mainland have helped trigger this economic boom.** The termination of the 40-year gaming monopoly at the beginning of 2002, as well as the closer economic cooperation with ~~Mainland China~~ the Chinese mainland since 1999, including the implementation of the Closer Economic Partnership Arrangement (CEPA) between ~~Mainland China~~ the Chinese mainland and MSAR, have been key to the positive economic developments. MSAR has also benefited from the liberalization of travel policy under the "Individual Traveler Scheme" by ~~Mainland China~~ the Chinese mainland. The economy, however, has become less diversified over the past decade and it is estimated that gaming/tourism related activity account now for about two thirds of GDP, up from one third a decade earlier. The government has increased its efforts to diversify the economy, including through the promotion of the convention and entertainment industry and addressing bottlenecks in the transportation infrastructure.

7. **Under the currency board arrangement, fiscal policy is the primary tool for countercyclical economic management.** The local currency—the pataca (MOP)—has been pegged to the Hong Kong dollar since 1977 at a middle rate of 1.03 and is 100 percent backed by foreign assets under the currency board arrangement (CBA). With capital freely mobile,<sup>8</sup> monetary conditions in MSAR are strongly influenced by conditions in the HKSAR and the United States market. Fiscal policy has traditionally been conducted in a prudent and conservative manner, visible in fiscal surpluses since 2002 (14 percent of GDP in 2007), no public debt, substantial fiscal reserves (about 50 percent of GDP), and a Moody's Aa3 sovereign rating.<sup>9</sup> The conservative fiscal stance, along with international reserves exceeding patacas M2 (119 percent at end-March 2008), have helped underpin confidence in the currency peg and the financial system.

<sup>7</sup> Macao SAR, MSAR, and Macao are used interchangeably.

<sup>8</sup> There are no exchange restrictions on current and capital account transactions.

<sup>9</sup> By comparison, HKSAR has a Aa2 rating. Although similar, Moody notes that Macao SAR's rating is one notch lower than HKSAR because of its dependence on one sector, and hence greater vulnerability to shocks.

8. **While the overall outlook for MSAR is positive, the economy is vulnerable to external shocks owing to its dependence on gaming.** The economy will continue to benefit from the positive prospects of the gaming/tourism industry and for the regional economies, as well as from closer economic regional integration. Owing to its high dependence on gaming related activity, the economy is vulnerable to shocks affecting international travel, the neighboring economies, and policy changes affecting gaming, including those that affect Mainland China the Chinese mainland's "Individual Traveler Scheme."<sup>10</sup>

**Table 1. Macao SAR: Selected Economic Indicators**  
(In percent)

	2002	2003	2004	2005	2006	2007	2008
<b>Real Sector</b>							
Real GDP growth (annual)	10.1	14.2	27.3	6.9	16.5	25.3	13.2
	(In millions of patacas)						
Gross domestic product	54,819	63,566	82,234	92,191	113,709	149,457	171,867
Gross fixed capital formation	5,801	8,982	13,422	24,768	39,330	54,187	49,474
Fixed Investment (In percent of GDP)	11	14	16	27	35	36	29
Exports (in percent of GDP)	104	103	104	94	89	88	90
Imports (in percent of GDP)	64	61	62	63	64	65	66
GDP in US dollars (In millions)	6,824	7,949	10,267	11,543	14,203	18,603	21,531
<b>Prices and Labor Market</b>							
Inflation (annual)	-2.6	-1.6	1.0	4.4	5.1	5.6	8.6
Property prices (residential, in patacas, annual, MOP per square meter of usable area)	6,261	6,377	7,984	10,024	10,578	13,649	...
Property prices (residential, annual, per square meter of usable area)	...	1.9	25.2	25.6	5.5	29.0	...
Earnings (annual, MOP)	4,672	4,801	5,167	5,773	6,701	7,800	...
Earnings (annual)	0.3	2.8	7.6	11.7	16.1	16.4	...
Unemployment rate	6.3	6.0	4.9	4.1	3.8	3.1	...
Population (In millions; mid-year estimates)	0.45	0.46	0.47	0.47	0.48	0.53	0.55
<b>Money and banking</b>							
Lending rate	6.1	6.0	6.0	7.0	8.8	7.8	...
Deposit rate	0.6	0.3	0.1	1.6	2.8	2.9	...
M2/GDP	180.5	174.8	147.1	147.2	148.5	124.1	110.4
Hong Kong dollar deposits/M2 1/	51.8	53.5	54.7	51.7	53.9	54.7	52.3
Reserve coverage (international reserves/broad money)	30.8	31.3	36.0	39.4	43.3	57.3	67.0
Net foreign assets/GDP	178.7	180.5	158.9	161.8	168.9	144.8	135.7
Private sector credit/GDP	59.0	50.2	42.3	46.4	42.8	46.9	52.3
Private sector credit growth	-7.4	-1.3	9.0	23.0	13.9	44.0	28.2
<b>Balance of payments</b>							
	(In millions of U.S. dollars; end of period)						
Current account, n.i.e.	2,719	3,160	4,240	3,367	2,928	5,863	...
(In percent of GDP)	39.8	39.9	41.4	29.3	20.6	31.5	...
Goods: Exports f.o.b.	2,358	2,585	2,815	2,478	2,560	2,545	...
Goods: Imports f.o.b.	-3,277	-3,678	-4,657	-5,271	-6,496	-7,638	...
Trade balance	-920	-1,093	-1,842	-2,792	-3,936	-5,094	...
Net foreign investment	346	519	848	1707	2131	3511	...
Exchange rate (Patacas per US\$; end of period)	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Moody's sovereign rating	Baa1	A1	A1	A1	A1	Aa3	Aa3

Source: IMF, International Financial Statistics, AMCM and Moody's.

1/ Includes only resident deposits.

<sup>10</sup> This scheme, which began in mid 2003, allows travelers from Mainland China the Chinese mainland to visit HKSAR and MSAR on an individual basis.

## B. Financial Sector Setting

### Overview

9. **Macao SAR financial system is large relative to the size of its economy.** Total financial sector assets amounted to MOP 412 billion at September 2008 (about US\$ 51 billion), equivalent to more than 307 percent of GDP. Compared, however, to other financial centers, MSAR's financial sector is of mid-size, with significant cross-border exposure. External assets account for about 60 percent of total financial assets, with most of MSAR's high level of domestic savings channeled abroad. This reflects the small and narrow economic base, the high foreign ownership of the financial system and the close proximity to the HKSAR financial center. Offshore financial activity is relatively small, accounting for ~~13~~<sup>46</sup> percent of banking assets.

10. **The financial system of Macao SAR is mainly bank oriented and foreign owned.** The system includes credit institutions—mostly banks—and noncredit institutions, primarily insurance companies. Banking assets account for more than 94 percent of total financial sector assets:

- **There are 30 credit institutions comprised of 27 commercial banks**, one government-owned postal savings bank, a store value card issuer, and one finance company (nondeposit taking). Of the commercial banks, 11 are locally incorporated and 16 are branches of foreign banks. Three of the commercial banks are offshore banks (two branches and one subsidiary, and all Portuguese owned).
- **There are 26 insurance companies (11 life and 15 nonlife companies; there are no offshore licensed companies).** All but two are branches or subsidiaries of foreign entities. Total net premiums amounted to US\$ 403 million (a 30 percent increase from 2006) against US\$ 1.5 billion of assets at end-2007. The industry is concentrated, with the top four insurance companies (both in life and nonlife) accounting for 85 percent of gross premiums. There are few linkages between banks and insurance companies in Macao SAR, reflecting also the 15 percent limit on banks' ownership of insurance companies.
- **Other noncredit financial institutions include:** 2 securities brokers (branches of HKSAR based companies), 11 bureau de change, 2 cash remittance companies, and 6 exchange counters (operating within casinos). Although permitted by law, there are no trust nor asset management companies active in MSAR.
- **While outside the offshore financial center**, there are 542 nonfinancial companies that are incorporated and operating in MSAR with physical presence. These involve mainly “back office” activities for their HKSAR parents and data processing and advisory services.

**Table 2. Macao SAR: Structure of the Financial System**

(In MOP millions, unless otherwise stated)

	2001	In % of total financial assets	2004	In % of total financial assets	2007	In % of total financial assets	2008 Q3	In % of total financial assets
<b>Financial Sector Assets</b>	146,182	100	179,941	100	347,681	100	411,896	100
In percent of GDP	294		217		229		307	
<b>Deposit-taking financial institutions</b>	142,315	97.4	171,028	95.0	327,763	94.3	389,672	94.6
Banks	142,315	97.4	171,028	95.0	327,749	94.3	389,649	94.6
Private banks	16,457	11.3	23,651	13.1	31,190	9.0	1,796	0.4
State-owned	1,109	0.8	1,055	0.6	1,255	0.4	1,190	0.3
Foreign-majority owned	124,748	85.3	146,322	81.3	295,304	84.9	386,662	93.9
Subsidiaries	60,945	41.7	70,448	39.2	135,619	39.0	166,272	40.4
Branches of foreign banks	63,803	43.6	75,874	42.2	159,686	45.9	220,390	53.5
Deposit-taking specialized financial institutions	0	0	0	0	14	0	23	0
<b>Non-Bank Financial Institutions</b>	3,868	2.6	8,913	5.0	19,918	5.7	22,224	5.4
Finance Companies	54	0.0	65	0.0	77	0.0	79	0.0
Credit Fonciers	0	0.0	0	0.0	0	0.0	0	0.0
Insurance companies	3,814	2.6	6,764	3.8	16,252	4.7	18,036	4.4
Life	2,973	2.0	5,924	3.3	14,449	4.2	15,995	3.9
Nonlife	841	0.6	841	0.5	1,804	0.5	2,041	0.5
Securities dealers (brokers)	n.a.	n.a.	38	0	88	0	65	0.0
Pension Funds	n.a.	n.a.	2,046	1.1	3,501	1.0	4,044	1.0

Source: AMCM

11. **There is no capital market in Macao SAR.** There is only an interbank market, although activity among banks is very low. Banks manage their pataca liquidity mainly through the standing facilities of the AMCM and their foreign currency liquidity through the Hong Kong market. As for securities trades for clients and for financial institutions' own accounts, they are executed on international exchanges via authorized foreign financial counterparts, while banks and investment managers are not allowed to be remote members of overseas stock or derivatives exchanges. There are less than a dozen local nonfinancial companies listed on the HKSAR Stock Exchange.

12. **One unique feature of MSAR's financial system is the wide use of the Hong Kong dollar (HK\$) for transaction and store value purposes.** The HK\$ accounts for about 50 percent of banks' assets (over 60 percent of bank loans) and deposits, and a large portion of currency in circulation. The purchases of goods and services and assets in HK\$ is widespread in MSAR. The use of HK\$ and pataca for gaming purposes is permitted.

### Banking sector

13. **Macao's banking sector is foreign owned, potentially creating supervisory challenges for host-home issues.** [The Chinese mainland](#)~~Mainland Chinese~~, Hong Kong and Portuguese ownership dominate the sector. All but two commercial banks (whose combined

business represents less than 1 percent of total banking assets in MSAR) are either subsidiaries or branches of foreign banks. ~~The Chinese mainland Chinese~~ Mainland Chinese-owned banks dominate the market, with the Bank of China (BOC, operating on a branch basis) effectively accounting for 40 percent of the market when aggregated with Tai Fung Bank (50.3 percent owned by BOC).<sup>11</sup> Notwithstanding this dominance, the market appears competitive with the Herfindhal Hirshman Index (HHI) valued at 1314.<sup>12</sup> Net interest margins around 1.4 percent are also not out of line with competitive systems.

14. **Offshore banking activities are relatively small.** There are three offshore banks. Their total assets and deposits account for about 13 percent of total banking assets and deposits respectively. These offshore banks operate in Macao mainly because of exemptions from income tax and industrial tax (annual fee for business registration). They may not transact with residents (including the locally incorporated companies and the branches of foreign companies operating in MSAR), and they can only transact in currencies other than the local currency. Other than having a lower capital requirement, the same supervisory regime applies to offshore banks as to all banks.

15. **Banks engage mainly in traditional banking business—taking deposits, granting loans, and managing surplus liquidity.** Banks fund themselves primarily through domestic deposits while branches, if needed, can borrow liquidity from their parent banks. Banks can take deposits from non-residents (mainly retail customers ~~resided-residing in the Mainland China-Chinese mainland~~ or HKSAR, ~~and mainly customers residing in the EU for~~ offshore banks, ~~and customers resided in Europe~~). Non-resident deposits account for about 29 percent of total deposits. At 50 percent, the loan/deposit ratio remains low, reflecting limited lending opportunities, strong deposit growth owing to the favorable economic environment and fiscal surpluses (public sector deposits account for about 4 percent of total banking deposits), and a relatively high liquid asset ratio requirement (30 percent). Apart from investing in AMCM monetary bills, banks place the majority of their excess liquidity with their parent banks and offshore affiliates. Reflecting the liquid condition, interbank deposits with foreign financial institutions account for about 40 percent of banks' assets, with the bulk placed in the HKSAR market. There is very little off-balance sheet activity owing to little demand for hedging by customers. Foreign currencies are mainly transacted for the banks' customers, while banks themselves do little trading on their account. As such, market risk exposure is limited.

<sup>11</sup> The BOC and the fourth largest bank, the Banco Nacional Ultramarino (BNU), are among the oldest operating banks in MSAR; the headquarter of BOC and parent of BNU are state-owned; they are the note issuing banks for the government of MSAR and also act as treasury on behalf of the government. To issue notes, the two banks are required to submit HK\$s to the AMCM in return for noninterest-bearing certificates of indebtedness.

<sup>12</sup> The HHI index is calculated for a sample of 28 banks for which market data (based on assets) was available at May 2008. It is the sum of the squares of the market share for all banks. A HHI value between 1000 and 1800 indicates moderate concentration while a value above 1800 would suggest high concentration.

with foreign regulators and does so in practice. It further has signed MOUs with ~~Mainland China~~ the Chinese mainland, Portugal, and HKSAR, covering more than 90 percent of the banking sector. There is also an informal arrangement in place with the Taiwan Province of China (POC) financial regulators. Annual or Ssemi-annual meetings are held with the home country supervisors to exchange information on the condition of the MSAR operations and to seek information from the home country supervisors concerning issues that may affect the condition of the MSAR bank/branch. The AMCM conducts onsite and offsite supervision of both branches and subsidiaries.

31. **To make the cross border framework more comprehensive, the AMCM should include an assessment of the financial condition of the parent bank, of the country's economic conditions, and of the quality of the home country supervision.** As foreign bank branches and subsidiaries place their excess funds with the parent and play a critical role in MSAR's banking sector, it is important to actively engage with the home supervisor to understand the strength of the parent, the bankruptcy regime in the home country, and monitor transfer risk in the home country. Currently, the AMCM informally tracks events in the home country by monitoring financial publications, published annual statements and other public sources of intelligence in addition to its meetings with home supervisors. However, the effectiveness of risk monitoring can be enhanced by reviewing market reports on the country and parent banks. Depending on the results of the analysis, the AMCM could adjust the frequency and scope of examinations and increase visits to banks that are experiencing home country concerns. Currently, the onsite examination scope is the same for branches and subsidiaries.

32. **Cross-border cooperation and information sharing between AMCM and the home insurance regulators should be strengthened.** Currently, for more than half (which account for 35 percent of the market share) there are no such cross-border arrangements with the insurance regulators in the jurisdictions. Potential problems could go undetected. It would be best if most branches operating in Macao SAR be covered through MOUs agreed between the host and home supervisor so that all relevant supervisory information is shared.

## **B. Financial Safety Net**

33. **The AMCM has a number of policy measures in place that would help buffer the financial system in the event of a bank failure.** These include: requiring banks to maintain minimum reserve requirements;<sup>19</sup> a standing facility for liquidity management in pataca; and a liquid asset requirement of 30 percent. The standing facility is accessed at the initiative of commercial banks where they can place their excess pataca in return for AMCM monetary bills. The AMCM further provides emergency liquidity assistance through the

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<sup>19</sup> These are set at 3 percent of demand deposits, 2 percent of time deposits up to three months and 1 percent on time deposits of over three months.



discount window, consistent with its lender of last resort (LOLR) duties, as spelled out in the FSA. Access to this window is collateralized. However, the modalities governing access to the emergency facility should be more clearly spelled out. Access to the LOLR should be restricted to solvent but illiquid banks and an overall access limit should be defined.

34. **While the AMCM has a well defined bank resolution process, consideration should be given to developing a rapid remedial action framework in order to facilitate an orderly approach to addressing a banking problem.** The law describes in great detail and comprehensively the scope of actions that can be taken in the bank resolution and liquidation process. Trigger points have been established for internal use when capital levels fall below 12 and 10 percent but the required actions by the bank or the AMCM are not defined. These triggers, that is when regulatory falls below a legally required minimum, and the ensuing specific actions should be specified in the law. The role of the AMCM as central bank, and conditions under which it would provide liquidity along with the role of the government in the bank resolution and liquidation process should also be clarified. The role of the chief executive of Macao SAR should be restricted to ensure that the AMCM has full control over the enforcement of the resolution process and can act quickly and efficiently in the face of an emerging banking problem or broader banking crisis.

35. **Given a series of events in the global financial market, the Macao SAR Government announced on October 14, 2008 that it would provide full protection for customer deposits held with all banks authorized in Macao SAR.** Also, if necessary, it would provide sufficient liquidity and capital support to banks, for the purpose of maintaining the stability of the MSAR banking system and enhancing the protection of depositors. These measures will remain in force until the end of 2010 when a review will be taken in light of the situation then.<sup>20</sup>

36. **Following the expiration of the blanket guarantee, the government could consider introducing an explicit deposit insurance scheme.** Up to October 2008, there had been no formal scheme in place. The government has in the past provided financial assistance when a bank failed (as was the case of the Bank of Credit and Commerce International (BCCI) in the early 1998s). Having an explicit deposit insurance is a central component of a sound financial safety net. One of its main objectives is to avoid bank runs and to assure an orderly bank resolution process. Overall, in considering an explicit deposit insurance scheme (DIS), the government would need to make sure that it is governed by strong principles—for example, that it is explicitly and clearly defined in the law, includes mandatory membership by deposit taking financial institutions, sets coverage and payout limits, charges premiums, and widely disseminates information about the scheme to

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<sup>20</sup> The AMCM is reviewing the pros and cons of such a scheme, including studies on the relevant legal framework, scope of insurance coverage, form of participation, calculation of premium, fund management and operation model.



## APPENDIX II

### REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) FOR THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

#### Summary

1. **In general, there is a high level of compliance with the Basel Core Principles (BCP).** The body of laws, rules and regulations are comprehensive and well developed, and provide a solid framework for banking supervision. There has been significant improvement in a number of areas since the 2002 OFC assessment.
2. **Notwithstanding, a critical recommendation of the 2002 OFC assessment to amend the laws to address shortcomings in the operational independence of the AMCM as financial regulator remains an outstanding issue.** The AMCM continues to have inadequate legal independence and lacks final decision authority over critical supervisory issues.
3. **Going forward, the conduct of supervision will need to evolve from a more compliance approach toward a risk-focused one.** This would be in line with the risk-oriented regulations and guidelines issued over the past two years, with far greater emphasis on the comprehensive assessment of the risk profile of individual banks and financial systemic risk.

#### Introduction

4. **An assessment of BCP for Effective Banking Supervision was conducted as part of the Update OFC assessment of Macao SAR.**<sup>1</sup> The assessment of the BCP was based on the essential criteria and additional criteria. The organization assessed was the AMCM—the financial regulator and supervisor of commercial banks.
5. **The assessment covered three objectives:** (i) assess the implementation of the 2002 mission's recommendations; (ii) assess compliance with the BCP for Effective Banking Supervision, based on the 2006 revised principles; and (iii) review the framework for cross-border supervisory coordination and information sharing.

#### Information and methodology

6. **The assessors received prior to the mission start from the authorities their comprehensive self assessment and also had full access to all relevant staff within AMCM** (including the Banking Supervision Department, other Departments, such as Insurance, Statistics and Research, as well as members of the Board of Directors), and all the

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<sup>1</sup> The assessors were Mr. Jose Tuya (formerly with the Office of the Comptroller of the Currency, United States) and Mr. Michael Deasy, from the Irish Financial Services Regulatory Authority.

relevant laws governing the financial sector. The assessors also met a number of external parties, including the Secretary for Economy and Finance, six commercial banks, both branches and subsidiaries as well as an offshore branch of a foreign bank, the Bankers' Association, the Committee for the Registry of Auditors and Accountants, an audit and accounting firm and a legal firm.

### **Institutional structure**

7. **Responsibility for the regulation and supervision of the banking sector rests with the AMCM.** The legal basis for banking supervision is set down in the Financial System Act of Macao (Decree-Law No. 32/93/M, 1993, otherwise known as the FSA) and the Decree-Law No.14/96/M, 1996 (also known as the Charter), supporting Decree-Laws No.58/99/M, 1999, which deals with the offshore regime of Macao SAR; No.15/83/M, 1983, which deals with the finance companies, as well as No.38/97/M for money changers; No.39/97/M for exchange operators, and No.15/97/M for cash remittance companies.<sup>1</sup> The laws are supplemented by 16 notices and circulars of rules and guidelines dealing with capital adequacy, liquidity, market, country and other risks, internal controls, and anti-money laundering. The Banking Supervision Department (BSD) within the AMCM is responsible for the supervision of 30 credit institutions, 11 money changers (i.e., bureau de change), 2 cash remittance companies, 2 securities traders (with head offices in Hong Kong SAR), and 6 money exchange operators.

### **Preconditions for effective banking supervision**

8. **Macroeconomic management in Macao SAR has traditionally been conducted in a prudent and conservative manner.** This has helped provide stability to Macao SAR's financial system. Macao SAR has a currency board arrangement with the local currency, the pataca, pegged to the Hong Kong Dollar since 1977. By law, foreign exchange reserves must at least cover 100 percent of the monetary base. Fiscal policy, which can be used as a countercyclical instrument, is conservatively managed, and the government has no public debt, a substantial amount of fiscal reserves, and a Moody's Aa3 sovereign rating.

9. **Macao SAR has a well developed legal system that is heavily influenced by the Portuguese legal system.** Its legislative regime for issues relating to the efficient and smooth running of a banking environment is in place (e.g. insolvency, foreclosure, collateral).

10. **The accounting framework, however, is lagging somewhat.** Macao SAR is in the process of adopting IFRS. To date it has adopted 16 IFRSs, but for accounting issues not covered by these standards, the law simply states that accounts should be prepared in accordance with generally accepted accounting principles without specifying what is meant by "generally." In practice, many of the banks adopt the accounting standards of their overseas head office/parent, most of which are applying either IFRSs or standards drawn

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<sup>1</sup> Laws and regulations are available on AMCM's website at [http://www.amcm.gov.mo/rules\\_and\\_guidelines](http://www.amcm.gov.mo/rules_and_guidelines).