立法會
Legislative Council

LC Paper No. CB(1)1372/04-05

Ref. : CB1/BC/5/04

Background brief on
Banking (Amendment) Bill 2005

Purpose

This paper sets out the background of the Banking (Amendment) Bill 2005 and summarizes the major views and concerns expressed by Members when the proposed legislation was deliberated at the meetings of the Panel on Financial Affairs (FA Panel) on 5 July 2004 and 6 December 2004.

International standards in banking supervision

Basel I

2. The international standards in banking supervision are set by the Basel Committee on Banking Supervision[1] (BCBS). A key element of the BCBS's supervisory approach is the capital adequacy ratio (CAR) set out in the Basel Capital Accord adopted in 1988 (widely known as Basel I). Basel I introduced a capital adequacy measure for credit risk, including on and off-balance sheet assets, based on varying risk weights (0%, 20%, 50%, and 100%) assigned to different classes of assets (e.g. central governments and banks of Organisation for Economic Co-operation and Development countries, residential mortgages and non-bank private sector). The minimum CAR under Basel I is 8%, calculated by dividing a bank's capital base by its risk-weighted assets. Hong Kong has adopted Basel I and its subsequent amendments through legislation under the Third Schedule to the Banking Ordinance (BO) (Cap. 155).

Basel II

3. Since the current framework was first introduced, technological advancement, innovations in financial products as well as increasing globalization have dramatically changed the nature of banks' business and the risks they are running. As a result, the

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[1] The Basel Committee was established by the central bank governors of the Group of Ten countries. It formulates broad supervisory standards, provides guidance and recommends best practice in the area of banking supervision.

current framework has become too broad-brush and insufficiently "risk-sensitive" and has failed to capture many other risks that banks face.

4. In order to address the shortcomings of Basel I and respond more directly to recent financial developments, the BCBS issued in June 1999 a proposal for a New Basel Capital Accord to replace the 1988 framework.

5. After extensive consultation, the Basel Committee published in end-June 2004 a new capital adequacy framework (known as Basel II) to replace Basel I.

6. While retaining the main features of the 1988 Accord, the new Basel II standards are considerably more complex. Basel II is structured around three "pillars", namely

(a) Pillar 1 – minimum capital requirements

(b) Pillar 2 – supervisory review process

(c) Pillar 3 – market discipline

7. The first pillar broadly corresponds with the subject matter of the 1988 Accord. Basel II does not substantially alter the definition of bank capital contained in the 1988 Accord. The minimum 8 percent ratio of capital to risk adjusted assets is retained. Nonetheless, there are several important differences between the first pillar of Basel II and the 1988 Accord. The calculation of credit risk is much more detailed, with the intention of improving the accuracy of the measurement of this risk category. In addition, the first pillar also incorporates a measurement framework for market risk substantially the same as the Basel Committee had promulgated in its 1996 Market Risk Amendment and introduces a capital charge for operational risk for the first time. Bank supervisors are offered a menu of approaches for calculating each of these types of risk. In the case of credit risk, the primary choice will be between a standardised approach using a system of standardised risk weights, essentially a refinement of the 1988 Accord but using external ratings where available, and one which uses data on loan loss experience generated by banks' internal risk management systems (the "Internal Ratings Based" or IRB approach).

8. The second pillar is concerned with "supervisory review", that is, a supplemental assessment by bank supervisors of the adequacy of each bank's capital ratio based on an evaluation of the full range of risks to which the bank may be exposed, as well as its capacity for identifying and managing those risks.

9. The third pillar lays out, for the first time, the nature and type of information which bank regulators should expect banks to disclose to their counterparties and other market participants.

10. Major international banking groups are expected to implement Basel II globally with effect from 1 January 2007[2], in accordance with the timetable set by the BCBS. Those banks with a presence in Hong Kong will naturally expect to be able to use the Basel II approaches in their operations in Hong Kong.

Banking (Amendment) Bill 2005

11. The main purpose of the Banking (Amendment) Bill 2005 is to amend the BO to provide for the implementation of the requirements under the revised international capital adequacy framework ("Basel II") promulgated by the BCBS.

12. The Banking (Amendment) Bill 2005 also makes other miscellaneous amendments to the BO, including

(a) limiting the liability of managers of companies, for some offences under BO, to instances that are results of an act or omission on the part of the manager personally or of a person under his control;

(b) allowing a defence of "reasonable excuse" to some offences under BO;

(c) allowing the Monetary Authority (MA), i.e. the statutory office, to publish details of disciplinary decisions in respect of securities business of Authorized Institutions (i.e. banks and deposit-taking companies authorized under BO) (AIs); and

(d) allowing the Monetary Authority to vary the capital adequacy ratio of licensed banks to a maximum of 16%.

Consultation with the Panel on Financial Affairs

13. At its meeting on 5 July 2004, the FA Panel was briefed on the basic features of the New Basel Capital Accord (i.e. Basel II) and the plan for implementing the new capital framework in Hong Kong.

14. At its meeting on 6 December 2004, the FA Panel was briefed on the progress of the preparation for the implementation of Basel II in Hong Kong and the proposed amendments to be contained in the Banking (Amendment) Bill 2005.

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[2] This refers to the implementation date for the less advanced approaches to the calculation of capital charges for credit and operational risks. For the most advanced approaches, the BCBS has set the implementation date at 1 January 2008.

15. There was general support for the implementation of Basel II in Hong Kong. Panel members however expressed the following views and concerns:

(a) whether it was necessary to extend the upper end of the minimum CAR for licensed banks to 16%;

(b) it was important to ensure that the MA would exercise its statutory power to raise the minimum CAR for individual banks in a fair and consistent manner;

(c) the requirement under Pillar 2 of Basel II for a banking regulator to intervene if a bank's capital level became insufficient might adversely affect the operation of the bank;

(d) as the medium and small-sized banks in Hong Kong were expected to adopt the standardized or a more simplified approach in managing their risks, they might not fully benefit from the new capital regime and might become less competitive vis-à-vis large banks in the market;

(e) while the banking industry was in support of the proposed implementation of Basel II in Hong Kong, the industry was concerned about the cost implication of the proposal, such as the cost for banks to improve their risk management systems;

(f) whether AIs would be able to meet the proposed timetable for implementation of Basel II in Hong Kong given the substantial time and resources required to prepare for the implementation; and

(g) the reasons for incorporating two other proposed amendments in the Bill, i.e. those relating to vicarious liability of managers and publication of disciplinary action in respect of AIs' securities business.

16. The minutes of the two Panel meetings were circulated vide LC Paper Nos. CB(1)2513/03-04 and CB(1)741/04-05.

Major difference between the consultation draft of the Bill and the present Bill

17. In December 2004, the Hong Kong Monetary Authority (HKMA) consulted on the draft Banking (Amendment) Bill 2005. The consultation draft of the Bill mainly covers three major areas, namely the calculation of the CAR of AIs, the enhancement of the existing financial disclosure regime applicable to AIs and the introduction of capital and financial disclosure requirements for bank holding companies (BHCs). After consultation with the industry, HKMA had decided to respond to the industry comments by excluding from the Bill the provisions on BHCs.

The proposed supervisory regime for BHCs as contained in the consultation draft of the Bill

18. Basel II requires supervisors to review and evaluate banks' capital adequacy assessments and assess their compliance with minimum capital standards on a consolidated basis, i.e. taking into account the risks of the whole banking group. Thus the scope of application of Basel II is both to banks and to BHCs. The original framework of Basel II is designed to apply to BHCs, being parent entities within banking groups, as well as to individual banks. This is to ensure that the full range of risks to which a bank might be exposed from elsewhere in the group is captured in the risk assessment process.

19. During the consultation exercise conducted by HKMA in December 2004, some respondents queried how some aspects of the amendments for the introduction and monitoring of minimum CAR requirements in respect of BHCs would be applied in practice. Moreover, there appeared to be a general feeling that such a regime was not strictly necessary at this juncture, in particular because no consensus had yet emerged among banking regulators as to how exactly it should be implemented. In light of these comments and the fact that the existing powers of the HKMA under the BO in respect of controllers of AIs are for the time being broadly adequate to achieve the Basel II objective of ensuring that risks within banking groups can be captured, the HKMA has decided to respond to the industry comments by excluding from the Bill the provisions on BHCs. This will be revisited later when HKMA can see how other key regulators approach the issue.

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25 April 2005