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Banking (Amendment) Bill 2005

Hong Kong Monetary Authority

27 April 2005

Banking (Amendment) Bill 2005

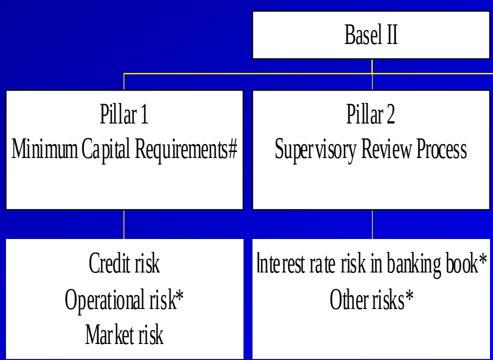
Background

Basel I (since 1988)

- The international standards in the field of banking supervision are set by the Basel Committee on Banking Supervision (BCBS)
- A key element of the BCBS approach is the capital adequacy ratio (CAR) set out in the Capital Accord adopted in 1988 (Basel I)
- $$\text{CAR (minimum 8\%)} = \frac{\text{capital base}}{\text{credit risk + market risk}}$$
- Basel I was adopted by HK through legislation under the 3rd Schedule to the Banking Ordinance (BO)

Basel II (June 2004)

- A more risk sensitive, thus more complex, 3-pillar framework to replace Basel I



$$\text{\# CAR (minimum 8\%)} = \frac{\text{capital base}}{\text{credit risk + market risk + operational risk}}$$

* new risks covered under Basel II

Approaches to measuring risks under Basel II

- Menu of approaches to measuring risks, in order of increasing sophistication, for banks to choose:
  - » Credit risk - Standardised Approach
    - Internal Ratings-Based (IRB) Approaches

    (Foundation IRB Approach, Advanced IRB Approach)
  - » Operational risk - Basic Indicator Approach
    - Standardised Approach
    - Advanced Measurement Approaches (AMA)
  - » Market risk - Standardised Approach
    - Internal Models Approach

Extensive public consultation

- The HKMA has consulted the industry and other interested parties extensively in developing the implementation proposals for Hong Kong, including the draft Bill.
- Parties consulted fully supported adoption of the revised capital adequacy standards under Basel II and raised no objections to the Bill.
- The HKMA has taken into account the comments received where appropriate in finalising the Bill.

Implementation of Basel II in Hong Kong

- The HKMA has planned to adopt the BCBS' implementation timetable for Basel II as from 1 January 2007.
- A new Basic Approach based on the current framework on credit risk but enhanced with additional requirements under Basel II will be made available to smaller Authorized Institutions (AIs).
- The choice of approaches is left to individual AIs so long as the HKMA is satisfied that AIs' choices are appropriate given the nature and scale of their activities, and sophistication of risk management.

Objectives of Banking (Amendment) Bill 2005 (The Bill)

- To provide for the introduction of revised banking supervision standards on capital adequacy of and related disclosure by AIs following the publication of Basel II by BCBS. The standards are <u>based on</u> Basel II but do not follow Basel II 100% as some adaptations have been made to accommodate local circumstances.
- To provide for other miscellaneous amendments to the BO to improve the working of its certain provisions in light of experience.

Main Provisions of the Bill

MA to make rules prescribing Disclosure and Capital matters (1)

- Clause 2 of the Bill amends section 60A of the BO to provide for the MA to make rules prescribing public disclosure requirements for AIs on their "CAR", in addition to their "state of affairs" and "profit and loss" - "Disclosure Rules".
- Clause 4 of the Bill adds new section 98A of the BO empowering the MA to make rules prescribing the manner of calculation of AIs' CAR - "Capital Rules".
- A definition of CAR and certain component factors (i.e. capital base and credit risk, operational risk and market risk) are to be defined in section 2 of the BO - section 1 of Part 1 of the Schedule to the Bill.

MA to make rules prescribing Disclosure and Capital matters (2)

- Clauses 2 and 4 of the Bill effectively confine the MA's power to make rules to the subject matters of Basel II, namely the calculation of CAR and the publication of information relating thereto.
- As subsidiary legislation, the rules will be subject to negative vetting by LegCo.
- The MA shall be obliged to consult the relevant parties before issuing the rules.
- Section 5 of Part 1 of the Schedule to the Bill provides for a mechanism of appeal to the Chief Executive in Council in respect of certain decisions of the MA made under the Capital Rules.

Proposed Contents of Capital Rules & Disclosure Rules

Capital Rules

- Will prescribe the calculation of the capital base, and the manner in which credit, market and operational risks are to be taken into account in calculating the CARs of AIs.

Disclosure Rules

- Will prescribe the information to be disclosed to the general public by AIs in relation to their state of affairs, profit and loss, and capital adequacy ratio as well as the manner in which, times at which and periods during which such information shall be disclosed.

Increase of ceiling of minimum CAR of licensed banks (1)

- To allow the MA more flexibility in setting the minimum CAR for individual licensed banks, which is capped at 12% under the existing section 101(1) of the BO, Clause 5 of the Bill amends that subsection to increase to 16% the maximum ratio to which the CAR of an AI (including licensed banks) may be varied by the MA
- No AI would have its minimum CAR increased based on our current assessment. This is a contingency power for use in case the risk of individual AIs, or of the sector as a whole, increases markedly from the current position.

Increase of ceiling of minimum CAR of licensed banks (2)

- The MA will issue guidelines setting out its approach for evaluating the capital adequacy of AIs, for the purpose of section 101(1) of the BO, including the factors to be considered by the MA in determining AIs' minimum CAR.
- Before exercising his power under section 101(1), the MA is obliged to consult the AI.

Scope of liability of managers under penal provisions (1)

- Clause 7 of the Bill adds section 2(18) to the BO so as to limit the liability of the "managers" of an AI for certain contraventions under the BO to cases where the contravention is caused or contributed to by an act or omission on the part of the "manager" himself or a person under his control.
- The term "manager" is defined in section 2(1) of the BO. In essence, it refers to the senior executives of an AI, who are not directors or chief executives of the AI.

Scope of liability of managers under penal provisions (2)

- Currently, liability for those contravention is imposed on every manager of the AI, on which the banking industry has expressed concern. The amendment is to address the industry's concern by confining the scope of liability of managers under the penal provisions.

Defence of "reasonable excuse"

- Clauses 10 & 11 of the Bill introduce a defence of "reasonable excuse" for offence provisions in sections 59(5) and 63(5) of the BO in relation to the requirements on AIs to submit auditors' reports and statutory returns to the MA.
- The amendment is proposed after a review of the penal provisions in the BO, and is considered necessary because contravention of those sections could be caused by reasons out of an AI's control, e.g. delay in completion of audit due to auditors' own problem.

Disclosure of disciplinary actions on AIs' securities business (1)

- Clauses 9 & 13 of the Bill seek to amend sections 58A and 71C of the BO to provide that the MA may disclose to the public certain details of his disciplinary action taken under those sections against a relevant individual or an executive officer who is engaged in securities business on behalf of an AI.
- At present, the MA may update the public register maintained under section 20 of the BO by including a record of any public disciplinary action taken by him against a relevant individual or an executive officer. However, he is precluded by section 120 of the BO from publishing the facts and findings of each case in relation to the disciplinary action taken by him against a relevant individual or executive officer.

Disclosure of disciplinary actions on AIs' securities business (2)

- As a standard practice, the SFC publishes the facts and findings of each public disciplinary action.
- The amendments seek to allow the MA to publish his disciplinary decisions in a manner similar to that followed by the SFC.

Legislative Timetable

- Early passage of the Bill is desirable
  - to ensure implementation according to BCBS timetable
  - to enable development of relevant rules and guidelines in consultation with the industry
  - to allow AIs sufficient time to make necessary preparations for implementation
- The HKMA aims to submit Capital Rules and Disclosure Rules for LegCo's negative vetting by mid-2006.

Banking Amendment Bill 2005

Questions and Answers