

立法會

Legislative Council

LC Paper No. CB(1)1872/04-05

Ref: CB1/BC/5/04

Report of the Bills Committee on Banking (Amendment) Bill 2005

Purpose

This paper reports on the deliberations of the Bills Committee on Banking (Amendment) Bill 2005 (the Bill).

Background

2. The international standards in banking supervision are set by the Basel Committee on Banking Supervision (BCBS) which was established by the central bank governors of the Group of Ten (G10)¹ countries. In July 1988, BCBS made public the “International Convergence of Capital Measures and Capital Standards”, which set down the agreement among the G10 central banks to apply common minimum capital standards to their banks, to be achieved by the end of 1992. It was known as the “Basel Capital Accord” and is now commonly referred to as “Basel I”. Basel I and its subsequent amendments were adopted in Hong Kong through legislation and are embodied in the Third Schedule to the Banking Ordinance (Cap. 155) (BO).

3. In June 2004, BCBS published a revised international capital adequacy framework commonly known as “Basel II”. Whilst Basel I recommended a minimum capital adequacy ratio (CAR) of 8% to cover credit and market risks, Basel II improves the capital framework’s risk-sensitivity and is more comprehensive.

¹ Comprising Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, United Kingdom and the United States.

4. Basel II has three main components (i.e. 3 Pillars). The first component (Pillar 1) provides a much more comprehensive measurement framework for *credit risk*², maintains basically the same framework for *market risk*³ and introduces a new capital charge for *operational risk*⁴. Although the minimum CAR remains at 8%, the new mechanism has made the basis of calculation more closely aligned to each bank's risk profile. Out of three available approaches to *credit risk*, a bank may choose one that seems most appropriate for the sophistication of its activities and internal controls. Among the three approaches, the *Standardized Approach* would utilize the ratings assigned to the bank by external agencies. The *Internal Ratings Based (IRB) Approach* would use internal rating model to quantify risks. A bank having adopted the IRB Approach could choose between the *Foundation IRB Approach* and *Advanced IRB Approach* depending on the level of sophistication of its rating systems. The second component (Pillar 2) refers to the supervisory review process. Each bank is required to assess the full range of risks and establish internal processes to assess its own capital adequacy on the basis of a thorough evaluation of all risks to which it is exposed. Banks are expected to hold capital above the regulatory minimum and supervisors must intervene at an early stage if capital levels became insufficient. The third component (Pillar 3) aims to bolster market discipline through public disclosure. Each bank would be required to disclose publicly key information on its capital, risk exposures and risk assessment and management.

5. According to the implementation timetable of BCBS, it is intended that Basel II could be implemented globally with effect from 1 January 2007 for the less advanced approaches to capital charge calculation. The most advanced approaches will be implemented from 1 January 2008. The Hong Kong Monetary Authority (HKMA), having consulted the industry and other interested parties, considers it highly desirable to adopt the revised capital adequacy regime and, through legislation, implement Basel II as from 1 January 2007 to tie in with BCBS's implementation timetable.

The Bill

6. The principal object of the Bill is to amend the BO to provide a framework for incorporating the revised capital adequacy framework under Basel II.

² This is the risk of loss to an institution arising from a counterparty's failure to perform on an obligation.

³ This is the risk of loss to an institution resulting from adverse movements in market rates or prices of its investments.

⁴ This is the risk of loss to an institution resulting from inadequate or failed internal processes, people and systems or from external events.

7. The Bill also proposes a number of miscellaneous amendments to the BO, including:

- (a) limiting the liability of managers of companies, for some offences under the 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 the 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. licensed banks, restricted licence banks and deposit-taking companies authorized under the BO) (AIs); and
- (d) allowing the MA to vary the CAR of licensed banks to a maximum of 16%.

The Bills Committee

8. The House Committee agreed at its meeting on 8 April 2005 to form a Bills Committee to study the Bill. Chaired by Hon Jeffrey LAM Kin-fung, the Bills Committee held a total of four meetings to discuss the Bill. The membership list of the Bills Committee is in **Appendix I**.

9. The Bills Committee has invited views from the public. A list of organizations which had given views to the Bills Committee is in **Appendix II**.

Deliberations of the Bills Committee

10. The Bills Committee notes that one of the major benefits of Basel II is to promote the adoption of stronger risk management practices by the banking industry, which would help enhance the safety and stability of the local banking sector. By enhancing internal risk management, banks will be able to assess their ability to offer to customers more sophisticated products such as derivatives, and assess lendings to sectors such as small and medium enterprises, and allow for better risk-adjusted pricing with lower lending rates for better customers. Therefore, both banks and their customers would benefit from the implementation of Basel II. On the global front, with Basel II representing international best practice in capital adequacy measurement and standards, implementation of Basel II in Hong Kong will also enhance Hong Kong’s reputation as an international financial centre. As such, the Bills Committee supports the implementation of Basel II in Hong Kong.

Implementation of Basel II

11. The proposed amendments to the BO for the purpose of implementing Basel II in Hong Kong basically relate to two major areas, namely CAR of AIs (Pillar 1), and enhancement of the existing financial disclosure regime applicable to AIs (Pillar 3). However, the Bill does not contain any substantive rules of Basel II. No specific provisions have been proposed for Pillar 2 as the review process could be covered by the existing powers of the MA provided in the BO.

Proposed rule-making power for MA

12. The current framework for regulating and measuring AIs' CARs is embodied in Part XVII of and the Third Schedule to the BO. These are supplemented by supervisory guidelines and technical notes issued by the MA from time to time. The proposed implementation of Basel II would involve a significantly more sophisticated approach to the calculation of CAR as compared with the present regime in the BO. The HKMA therefore proposes to adopt a rule making approach to save the ongoing need to update the regime in keeping up with industry developments and international practices. To this effect, clause 2 of the Bill provides for the MA to make rules prescribing public disclosure requirements for AIs on their financial affairs including CAR ("Disclosure Rules"); and clause 4 of the Bill provides for the MA to make rules prescribing the manner of calculation of the CAR of AIs ("Capital Rules"). Clause 5 increases to 16% the maximum ratio to which the CAR of a licensed bank may be varied by the MA.

13. Regarding the rationale for empowering the MA to make the Capital Rules and Disclosure Rules instead of amending the current Third Schedule of the BO, the Administration explains that given the fact that the method of calculating CARs under Basel II is considerably more complex than that currently specified in the Third Schedule to the BO, putting the revised regime into legislation through the existing approach, i.e. by incorporating all the detailed calculations in the Third Schedule, is neither practical nor cost-effective. In addition, to keep pace with both developments in the industry which impact on CARs and international practices which will evolve over time, there will be a need on a continuing basis to revise and keep up-to-date the CAR regime in Hong Kong. These necessitate modification of the existing process for putting into legislation the revised capital regime in Hong Kong. It is therefore proposed that a rule-making approach be adopted.

14. The Bills Committee notes that both the Capital Rules and Disclosure Rules to be promulgated are regarded as subsidiary legislation subject to negative vetting by the Legislative Council, although it has not been stated in the Bill. At the same time, the Bills Committee also notes that the Bill also proposes to amend section 7(3) of the BO to allow the MA to issue guidelines indicating

the manner in which he proposes to exercise functions conferred on him under these Rules. Such guidelines are not subsidiary legislation. The relevant extract of the amended section 7 of the BO is enclosed in **Appendix III**.

15. Members of the Bills Committee have questioned whether it is necessary to spell out clearly in the Bill that the Capital Rules and Disclosure Rules are subsidiary legislation. The Administration confirms that it is not necessary to do so as there should not be any doubt as to the status of the rules being subsidiary legislation. As for the guidelines, there is a general understanding that guidelines are not subsidiary legislation. Although there is a requirement for such guidelines to be published by notice in the Gazette, they are not subject to the negative vetting of the Legislative Council.

Public disclosure by AIs

16. The proposed new section 60A (clause 2) would give the MA the power to make rules prescribing public disclosure requirements for AIs on their financial affairs including CAR (i.e. Pillar 3). The power to make rules is subject to the statutory duty to consult the Banking Advisory Committee (BAC), the Deposit-taking Companies Advisory Committee (DTCAC), the Hong Kong Association of Banks (HKAB), the DTC Association (DTCA), and the Financial Secretary (FS).

17. The new section 60A(4) provides that where an AI fails to comply with any requirement applicable to it contained in rules made under the new section 60A(1), every director, every chief executive and every manager of the AI commits an offence and is liable on conviction upon indictment to a fine at tier 7 or on summary conviction to a fine at tier 5, and in the case of a continuing offence, to a further fine at tier 2 for every day during which the offence continues.

18. The Bills Committee has examined whether the new section 60A(4) is too stringent as based on the current drafting, even for a minor technical breach by an AI of any requirement applicable to it contained in rules made under the new section 60A(1), every director, every chief executive and every manager of the AI would commit an offence and would thus be subject to criminal prosecution. The Bills Committee has therefore examined the actions the MA would probably take in the case of a breach of the rules made under the new section 60A(1). The Bills Committee has also reviewed the power and actions that could be taken by the MA in respect of non-compliance with the provisions of the BO on the part of AIs.

19. According to the HKMA, in the BO, apart from criminal prosecution, there are a full range of alternative actions that the MA could take in respect of a contravention of a provision of the BO on the part of an AI. As the primary regulatory objective of the MA is to ensure stability of the banking system, the

primary concern of the MA is to address the relevant problem arisen in the first place. To this end, the MA would probably use moral persuasion in the first instance and this could be reinforced by exercising the powers given to it under section 52 of the BO. The new section 60A(4) imposes a strict liability on certain personnel of AIs and there are other similar provisions existed in the BO. Depending on the circumstances of the case, criminal prosecution against the personnel of the AI concerned might not be initiated, but this is a matter for the Department of Justice to decide, not the MA.

Definition of CAR and related terms

20. Clause 4 of the Bill adds new section 98A to the BO to provide for the MA, after consultation with the BAC, DTCAC, HKAB, DTCA, and the FS, to make rules prescribing the individual components 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 (i.e. Pillar 1).

21. The Bills Committee notes that the term “capital adequacy ratio” is defined in the Schedule to the Bill as the ratio of an AI’s capital base to a value representing the degree of credit risk, market risk and operational risk to which the institution is for the time being exposed. The Bills Committee has examined whether there is a need to refine the definition of the term to ensure clarity. The Bills Committee notes the respective definitions of “credit risk”, “market risk”, “operational risk” and “capital base” as defined in section 1 of the Schedule to the Bill. However, it is not certain how “value” in the phrase “... means the ratio of the institution’s capital base to a value representing” is arrived at.

22. The HKMA points out that the term “value” is an amount to be calculated on the basis of different types of assets or exposures of an AI, the assigned risk weights to the type of assets/exposures and the calculation methodologies under each of the approaches of Pillar 1. The proposed definition of “capital adequacy ratio” is arrived at after a lot of deliberation within the Administration. The MA would make rules to prescribe clearly the manner in which the CAR of AIs shall be calculated.

Appeals mechanism

23. On check and balance measures, the Bills Committee agrees that provisions on the mechanism for appeals and other procedural safeguards should be incorporated into the BO with regard to the decisions of the MA made under the Capital Rules. To this end, the Administration proposes a two-tier appeals mechanism. At the first tier, under the new section 98A(3), the rules made under section 98A(1) may provide for the MA, on application made to him by any person aggrieved by a decision made by the MA under those rules, to review his decision. At the second tier, an AI aggrieved by a decision made by the MA under those rules can also appeal to the Chief Executive in Council for a review

under the existing BO.

24. On the first-tier appeals mechanism, the Bills Committee notes that the Administration's intention is to establish an internal procedure for handling requests for review of the MA's decisions. Before invoking the formal appeal procedure, an aggrieved person may apply to the MA to review a decision made by the MA under the Capital Rules. On receipt of such a request, a review committee constituted by officials in the HKMA who are not directly involved in making the decision in question would be formed to review the decision. This procedure is in line with the normal approach adopted currently by the MA for resolving matters with the banking industry. Hence, proposed section 98A(3) would formalize the existing informal procedure. To reflect the policy intention, the Administration also proposes to move a Committee Stage amendment (CSA) to clause 4 to make it clear that an AI, instead of "any person", aggrieved by a decision of the MA made in relation to it under the Capital Rules could make an application for review of MA's decision.

25. The Bills Committee considers that the second-tier mechanism with the Chief Executive in Council being the appellate body, is not suitable for present-day circumstances. Since the Executive Council (ExCo) is primarily a body to assist the Chief Executive in policy making and that the ExCo may lack the time and expertise required to deal with such appeal cases, the Administration should consider establishing a specific appeal body for handling appeal cases relating to the decisions of the MA made under the BO, as in the case of the Securities and Futures Ordinance (Cap. 571), where a Securities and Futures Appeals Tribunal had been established to handle appeals against the decisions of the Securities and Futures Commission (SFC).

26. The Administration points out that the existing appeals mechanism in the BO, i.e. the Chief Executive in Council being the appellate body, has been in place for a long time and its appropriateness has not been questioned by the banking industry. During the public consultation on the Bill, the banking industry has expressed no objection to maintaining the existing mechanism.

27. Nevertheless, the Administration sees merit in members' proposal, given the technical nature of appeals under the Capital Rules, and agrees to move CSAs to the Bill to provide for the establishment of a tribunal that would review certain decisions of the MA made under the Capital Rules.

28. The Bills Committee has also examined the extent to which the decisions of the MA in relation to the Capital Rules would be appealable under the proposed amendments in the Bill. The Administration points out that the right of appeal will only lie in respect of the fundamental decision as to which approach to capital adequacy calculation an AI may adopt, which may have a material impact on the AI's capital requirement. The detailed calculation technicalities, which are to be prescribed in accordance with the international

standards of Basel II, would not be subject to appeal. The Capital Rules would be made after thorough industry consultation as proposed in clause 4 of the Bill. The Capital Rules would also specify which decisions of the MA made in the exercise of the power conferred on it by the Capital Rules would be subject to appeal.

29. In the course of deliberation, views have been expressed that the Administration should consider whether the existing appeals mechanism under the BO should also be revamped. The Administration's view is that for the moment, it does not see the need to change the appeals mechanism which has been working well and is accepted by the banking industry. It however agrees that this matter could be reviewed in future where necessary.

Power of MA to vary the capital adequacy ratio (clause 5)

30. The MA is empowered under section 101 of the BO to vary, after consultation with FS, the CAR of licensed banks to a maximum of 12% and that of deposit-taking companies and restricted licence banks to 16%. Clause 5 recasts section 101(1) to empower MA to vary the CAR of all AIs to a maximum of 16%. According to the Administration, such amendment is necessary to enable the MA to set a higher CAR if the circumstances so require, e.g. a significant increase in risks to which an individual bank or the industry as a whole is exposed.

Criminal liability of managers (clause 7)

31. Under the existing BO, if an AI breaches certain requirements in the BO, every director, every chief executive and every manager of the AI commits an offence and is liable to be prosecuted. The terms "director" and "chief executive" are self-explanatory. The term "manager" refers to a senior executive of an AI who is principally responsible for one or more of the important affairs or key business of the AI specified in the Fourteenth Schedule to the BO.

32. The Bills Committee notes that HKAB has previously expressed a concern that, since a manager is normally responsible for only one business area of an AI, it is unreasonable that he or she may be prosecuted for a contravention committed outside his or her area of responsibility. The Administration considers that the concern of the banking industry is not invalid. It therefore proposes adding a new section 2(18) to the BO (clause 7) so as to limit the liability of managers for certain contraventions to the case 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.

33. The Administration assures members that, notwithstanding the proposed amendments to limit the liability of managers of AIs under the BO,

there are sufficient incentives under the current regulatory regime for AIs to ensure compliance with the BO and the proper conduct of their business. It is unlikely that the proposed amendments would have any material impact on the interests of bank customers.

34. In this respect, the Bills Committee notes that the HKMA has also consulted the Consumer Council and HKAB on the Bill. Insofar as the proposed amendments relating to the liability of managers are concerned, the Consumer Council did not have any comments. HKAB, on the other hand, has put forward some suggestions, including replacing the strict liability offences by mens rea offences. These suggested changes have the effect of further reducing the liability of the managers of AIs in the event of a contravention of the BO. The HKMA does not consider it appropriate to incorporate these suggested changes into the Bill without first conducting a detailed analysis. In order not to delay the passage of the Bill, which is important to the implementation of Basel II in Hong Kong, the HKMA undertakes to review this matter in the next amendment exercise of the BO.

Disciplinary action in respect of relevant individuals and executive officers (clauses 9 and 13)

35. The MA has been empowered under the Banking (Amendment) Ordinance 2002 to use the same standards and approaches adopted by the SFC in the MA's front-line supervision of AIs' securities business. Currently, the SFC publishes its disciplinary action as well as the relevant facts and findings surrounding the case. Although the MA has been given similar powers under sections 58A and 71C of the BO, there is doubt as to whether the MA can publish his disciplinary actions in view of the confidentiality obligations imposed on him by section 120 of the BO. To maintain a level playing field between AIs and SFC regulated persons, the Bill provides new sections 58A(4A) and 71C(7A) in the BO to put it beyond doubt that the MA may publish his disciplinary decisions in a manner similar to that followed by the SFC.

Defence of "reasonable excuse" (clauses 10 and 11)

36. Clauses 10 and 11 introduce a defence of "reasonable excuse" to an offence for contravening section 59(2) (report on matters as MA may reasonably require for the exercise of his functions under the BO) or section 63(1) (submission of monthly and quarterly return), or failing to comply with any requirement under section 63(3) or (3A) (submission of an auditor's report as specifically required by MA before a specified date) of the BO. The amendments would mitigate the harsh effect of the relevant provisions.

Committee Stage amendments

37. The Administration has accepted the Bills Committee's suggestion to move CSAs to the Bill to provide for the establishment of a tribunal that would review certain decisions of the MA made under the Capital Rules. The Administration has also accepted members' suggestion to refine the CSAs to allow the tribunal to publish its determination and the reasons for the determination under certain circumstances (e.g. if the publication would be a useful reference for the banking industry). The Bills Committee will not propose any CSAs.

Recommendation

38. The Bills Committee supports the Bill and recommends the resumption of the Second Reading debate on the Bill on 6 July 2005.

Consultation with the House Committee

39. The House Committee at its meeting on 17 June 2005, supported the recommendations of the Bills Committee in paragraph 38 above.

Council Business Division 1
Legislative Council Secretariat
22 June 2005

Bills Committee on Banking (Amendment) Bill 2005

Membership list

Chairman	Hon Jeffrey LAM Kin-fung, SBS, JP
Deputy Chairman	Hon Bernard CHAN, JP
Members	Dr Hon David LI Kwok-po, GBS, JP Hon CHAN Kam-lam, JP Hon SIN Chung-kai, JP Hon Andrew LEUNG Kwan-yuen, SBS, JP Hon Ronny TONG Ka-wah, SC (Total : 7 Members)
Clerk	Mr Andy LAU
Legal Adviser	Mr KAU Kin-wah
Date	27 April 2005

Appendix II

Bills Committee on Banking (Amendment) Bill 2005

List of organizations which have given views on the Bill

1. Hong Kong Institute of Certified Public Accountants
2. Office of the Privacy Commissioner for Personal Data, Hong Kong
3. Securities and Futures Commission

Council Business Division 1
Legislative Council Secretariat
16 June 2005

7. Functions of Monetary Authority

(1) The principal function of the Monetary Authority under this Ordinance shall be to promote the general stability and effective working of the banking system. (*Amended 82 of 1992 s. 15*)

(2) Without limiting the generality of subsection (1), the Monetary Authority shall— (*Amended 82 of 1992 s. 25*)

- (a) be responsible for supervising compliance with the provisions of this Ordinance;
- (b) take all reasonable steps to ensure that the principal places of business, local branches, local offices, overseas branches and overseas representative offices of all authorized institutions and local representative offices are operated in a responsible, honest and business-like manner; (*Amended 32 of 2001 s. 3*)
- (c) promote and encourage proper standards of conduct and sound and prudent business practices amongst authorized institutions and money brokers; (*Amended 4 of 1997 s. 4*)
- (d) suppress or aid in suppressing illegal, dishonourable or improper practices in relation to the business practices of authorized institutions;
- (e) co-operate with and assist recognized financial services supervisory authorities of Hong Kong or of any place outside Hong Kong, whenever appropriate, to the extent permitted by this or any other Ordinance; (*Amended 95 of 1991 s. 4; 6 of 2002 s. 3*)
- (f) consider and propose reforms of the law relating to banking business and the business of taking deposits; and (*Amended 6 of 2002 s. 3*)
- (g) take all reasonable steps to ensure that any banking business, any business of taking deposits, or any other business, carried on by an authorized institution is carried on—
 - (i) with integrity, prudence and the appropriate degree of professional competence; and
 - (ii) in a manner which is not detrimental, or likely to be detrimental, to the interests of depositors or potential depositors. (*Added 6 of 2002 s. 3*)

(3) The Monetary Authority may from time to time cause to be prepared and published by notice in the Gazette, ~~for the guidance of authorized institutions, guidelines not inconsistent with this Ordinance, indicating the manner in which he proposes to exercise functions conferred or imposed by this Ordinance upon him.~~ (*Amended 82 of 1992 s. 25*)



guidelines indicating the manner in which he proposes to exercise functions conferred or imposed by or under this Ordinance upon him.