

For information
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Legislative Council Panel on Financial Affairs

Progress in Implementation of Basel II Enhancements and Plan to Implement Basel III

PURPOSE

This paper seeks to –

- (a) report on the progress of implementing the package of enhancements to the Basel II regulatory capital framework issued by the Basel Committee on Banking Supervision (“BCBS”) in July 2009; and
- (b) outline the new regulatory capital and liquidity standards issued by the BCBS in December 2010, known as “Basel III”, and our plan to implement Basel III in Hong Kong starting 1 January 2013.

ENHANCEMENTS TO BASEL II

Existing Basel II capital adequacy framework

2. The BCBS is a standard-setting body which promotes sound standards of banking supervision globally. A key element of the BCBS’ work is the development of the supervisory framework governing the capital adequacy of internationally active banks, which is known as Basel II. Basel II, introduced since 2007, is composed of three pillars: (i) minimum capital requirements for a bank’s credit, market and operational risks (“Pillar 1”); (ii) supervisory review process to evaluate and monitor the bank’s capital adequacy in relation to its overall risk profile (“Pillar 2”); and (iii) disclosure requirements to allow market participants to access key pieces of information on the bank’s capital adequacy (“Pillar 3”).

3. The existing capital adequacy framework in Hong Kong is set out in (i) Part XVII of the Banking Ordinance (“BO”) (Cap. 155), which prescribes capital adequacy ratio requirements for locally-incorporated authorized

institutions (“AIs”); and (ii) the Banking (Capital) Rules (“B(C)R”) and the Banking (Disclosure) Rules (“B(D)R”) made by the Monetary Authority (“MA”) under the BO. The B(C)R prescribe how the capital adequacy ratios (“CAR”) of locally-incorporated AIs are to be calculated and the B(D)R prescribe what information on state of affairs, profit and loss, and CAR is to be publicly disclosed by AIs, in line with the recommendations under Pillar 1 and Pillar 3 respectively of the Basel II framework. These Rules are supplemented by supervisory guidance. The Hong Kong Monetary Authority (“HKMA”) has developed and undertaken a supervisory review process under Pillar 2 of Basel II since 1 January 2007.

Enhancements to Basel II

4. As part of its strategy to address weaknesses in the banking sector revealed by the global financial crisis, the BCBS published a package of enhancements to Basel II (collectively known as “Basel II Enhancements”) in July 2009, covering –

(a) Revisions to the Basel II market risk framework

These proposals seek to increase both the extent of the risks captured by the market risk framework and the capital charge against banks’ exposures booked in their trading books as well as to reduce the procyclicality of the market risk capital requirements. The proposals include the introduction of an incremental risk charge (“IRC”), a stressed value-at-risk calculation and the subjecting of securitised products booked in the trading book (with limited exceptions) to the higher capital charges applicable to securitised exposures held in the banking book;

(b) Guidelines for computing capital for incremental risk in the trading book

These guidelines provide additional guidance on the principles and parameters for computing the IRC; and

(c) Enhancements to the Basel II framework

These cover (i) the increased capital requirements for certain securitization exposures under Pillar 1; (ii) supplemental Pillar 2 guidance to address observed flaws in the governance and risk management practices of banks (including risk aggregation, risk concentration, risk evaluation, valuation practices, reputation risk,

liquidity risk, remuneration practices and stress-testing); and (iii) additional disclosure requirements under Pillar 3 to improve the transparency of banks' balance sheets in the context of their securitization activities and their exposures to market risk.

5. The BCBS expects banks and supervisors to implement the supplemental guidance under Pillar 2 immediately, and to implement the enhancements related to Pillar 1 (capital requirements) and Pillar 3 (disclosures) by 31 December 2011.

Progress of implementation

6. We are supportive of the Basel II Enhancements and propose to implement the enhancements in line with the timetable set by the BCBS. As the first step, the HKMA issued on 4 June 2010 the revised framework and guidelines for the implementation of Pillar 2, which came into operation on the same day. On the enhancements relating to Pillar 1 and Pillar 3, which would involve legislative amendments, the HKMA consulted the banking industry in September 2009 and August 2010 on its implementation proposals covering the proposed amendments to the B(C)R and the B(D)R as well as its intention to put the amendments into effect starting 1 January 2012. In response to the consultations, the industry sought clarification on various technical issues and noted the need to avoid double-counting and over-estimation of risks and, in some cases, the substantial system development which would be required to ensure compliance. That said, the banking industry was generally supportive of the proposed enhancements and the implementation timetable.

7. We are now preparing the necessary amendments to the B(C)R and the B(D)R for giving effect to the Basel II Enhancements. Apart from the aforementioned enhancements, opportunity will be taken to make a few refinements and clarifications to the B(C)R with a view to addressing some issues and ambiguities identified in the operation of the B(C)R in Hong Kong to date.

8. The draft amendments to the B(C)R and the B(D)R are subject to statutory consultations before they can be finalized for tabling at the Legislative Council ("LegCo") for negative vetting. Our plan is to issue the draft legislative amendments in Q3 2011 for statutory consultations pursuant to the relevant provisions in the BO and table them for negative vetting by LegCo in Q4 2011. Subject to LegCo's consideration, we hope to put the amendments into effect from 1 January 2012 in line with the BCBS' timetable.

BASEL III

Major elements of the reform package

9. Following the release of the Basel II Enhancements discussed above, the BCBS continued in its objective to strengthen the global capital framework and the resilience of the banking sector. To this end, in December 2010 and January 2011, the BCBS issued (i) further capital requirements designed to raise the quality, consistency and transparency of banks' capital base; and (ii) new global liquidity standards. These requirements and standards are collectively known as "Basel III". Through Basel III, the BCBS aims to improve the banking sector's ability to absorb shocks arising from financial and economic stress, thus reducing the risk of spillover from the financial sector to the real economy.

10. The main elements of the Basel III framework include –

A. Strengthening the global capital framework

- (a) Enhancing the quality of banks' regulatory capital base by (i) introducing more stringent qualifying criteria for capital instruments to be allowed for inclusion in the "tiers" of recognized capital resources for regulatory purposes, i.e. Tier 1 capital (which includes common equity and other capital instruments which are perpetual and have no incentive to redeem; which are subordinated to depositors, general creditors and subordinated debt; and in respect of which the bank has full discretion to cancel any dividend or coupon payments) and Tier 2 capital (which includes debt instruments which have an original maturity of at least five years and no incentives to redeem; and which are subordinated to depositors and general creditors); and (ii) applying harmonised regulatory adjustments (deductions) to the common equity component of the capital base;
- (b) Increasing the minimum capital adequacy ratio requirements in relation to risk-weighted assets, with the common equity requirement rising from 2% (before the application of regulatory adjustments) to 4.5% (after the application of stricter regulatory adjustments); and the Tier 1 capital requirement rising from 4% to 6%;
- (c) Improving the transparency of the capital base by requiring all

elements of capital to be disclosed along with a detailed reconciliation to the bank's reported accounts;

B. *Reducing procyclicality*

Requiring banks to hold buffers of capital above the regulatory minimum which they can use during periods of stress. Basel III establishes an equity "capital conservation buffer" of 2.5% of risk-weighted assets which can be extended in periods of excessive credit growth by the addition of a "countercyclical capital buffer" ranging from 0% in normal times up to 2.5% of risk-weighted assets during periods of excessive credit growth associated with the build-up of system-wide risk. Restraints will be imposed on distributions by a bank when its capital level falls into the buffer range;

C. *Supplementing the risk-based capital requirements with a leverage ratio*

Introducing a simple leverage ratio designed to constrain the build-up of excessive leverage in the banking sector and provide an additional safeguard against model risk and measurement error in the risk-based capital adequacy calculation;

D. *Enhancing risk coverage*

Strengthening the capital requirements for counterparty credit risk exposures arising from banks' derivatives, repo and securities financing activities through, among other things, the imposition of capital charges for mark-to-market losses, and the use of stressed inputs in the calculation; and

E. *Introducing global liquidity standards*

Introducing two minimum standards, namely, the Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR"), for funding liquidity. The LCR aims to ensure that banks have a sufficient stock of high-quality liquid assets to meet their contingent liquidity needs and survive for at least 30 days under a supervisor-defined scenario combining an idiosyncratic and market-wide shock. Complementing the LCR, the NSFR aims to ensure that banks' estimates of "required stable funding"

over one year under conditions of extended stress is met by their estimate of “available stable funding” from reliable funding sources.

BCBS’ implementation schedule

11. Basel III will be phased in gradually to enable the global banking sector to move to the higher capital and new liquidity standards while continuing to support economic activities through lending and other banking business. The BCBS expects its member jurisdictions to begin the implementation of Basel III from 1 January 2013, with full implementation by 1 January 2019.

12. Given that the leverage and liquidity ratios are new and as yet untried and untested, the BCBS has provided observation periods, within its transitional phase-in arrangements, to allow the ratios’ operation and effects to be monitored before they are formally implemented as minimum standards. Robust data reporting and assessment processes will be put in place during the observation periods, entailing additional quantitative impact assessment exercises commencing later this year. The BCBS will take into account the results of the assessments in finalising these standards. These ratios may therefore be subject to further change.

Industry feedback

13. The HKMA has kept the banking industry informed of the developments with respect to Basel III and encouraged the industry associations to provide their comments to the BCBS during its consultations. The Hong Kong Association of Banks (“HKAB”), in its response to the BCBS, indicated its members’ support for the underlying objectives of the Basel III recommendations to strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector. However, HKAB indicated the need to be mindful of the combined effects of all of the proposals and any potential unintended consequences of the reform measures. HKAB also stressed the need for consistency, international harmonization and appropriate transitional provisions, as well as raised technical issues on calculation methodologies.

14. The BCBS has taken into account the comments received from its consultations and the results of its comprehensive quantitative impact study to assess the impact of the Basel II Enhancements and the Basel III capital and liquidity standards. In particular, the extended transition period for implementing the Basel III capital and liquidity standards should provide banks

with ample time to move to the new standards. The observation periods will be used to ensure that the design and calibration of the leverage ratio and the liquidity standards are appropriate and that any unintended consequences are adequately addressed, at either the banking sector or the broader financial system level.

Impact of Basel III on AIs in Hong Kong

15. In Q1 2010, the HKMA conducted a local quantitative impact study to assess the impact of Basel III on selected local banks in Hong Kong. Given that banks in Hong Kong are generally well-capitalised and have traditionally placed significant reliance on common equity to meet regulatory capital requirements, and that most of the Basel III regulatory adjustments are already required to be deducted from Tier 1 capital under Hong Kong's existing capital rules, local banks should be well-placed to meet the higher capital requirements. Similarly, the HKMA does not anticipate major problems for local banks to comply with the new liquidity standards over the course of the transition period although some may need to adjust their liquidity profiles or the composition of their liquid assets.

Implementation of Basel III in Hong Kong

16. It is our current intention to implement Basel III in Hong Kong in accordance with the BCBS' timetable, including the transitional arrangements. On 26 January 2011, the HKMA issued a circular letter to all AIs indicating its initial thinking on implementation (including the anticipated timetable) in order to provide a backdrop against which AIs can develop their own plans for bringing their organizations into compliance with the Basel III requirements.

17. The implementation of Basel III in Hong Kong will entail amendments to the BO, the B(C)R and the B(D)R. The proposed new capital and liquidity standards are wider and considerably more complex than the existing requirements and, as recently demonstrated by the global financial crisis, there will be a need to keep the standards proactively under review and to amend and refine them swiftly as necessary to address changing business practices as well as changes in the financial environment and to reflect best practice in international standards. To accommodate the complexity and to provide an appropriate platform for swift, proactive response, we propose to build upon the existing rule-making powers in the BO for the B(C)R and the B(D)R and seek to empower the MA to make rules specifying (i) the capital and liquidity requirements for AIs and (ii) the requisite disclosure to be made by AIs in respect of their compliance with such requirements. Such rules would be subsidiary legislation and subject to statutory consultations on the same basis

and with the same bodies as those applicable to the current B(C)R and B(D)R.

18. Under our proposal, the HKMA could supplement the rules by promulgating codes of practice or technical memoranda to explain, provide guidance and assist with the technical and complex calculation methodologies in relation to the capital and liquidity requirements.

19. The HKMA would have a power to vary the capital and liquidity requirements applicable to an AI, after consultation, where the HKMA considers it prudent to do so, taking into account the risks to which the AI is exposed or the liquidity needs of the AI. This should accommodate the Pillar 2 supervisory review process. A mechanism to vary the capital requirements to reflect the operation of the countercyclical capital buffer will also be required.

20. The use of rules, supplemented by codes of practice, should provide a practical means to handle, within the legislative framework, the required range of complex calculation methodologies and the need for flexibility to effect changes relatively quickly in response to changing circumstances and developing international standards.

21. We have set in train the necessary work for preparing the amendments to the BO in accordance with the proposed approach outlined above. In addition, the HKMA will conduct preliminary industry consultation on the proposed approach shortly. We will take into account the relevant comments received through the preliminary consultation in preparing the legislative amendments and conduct a further industry consultation on the draft amendments at the next stage. Our plan is to introduce the legislative amendments into LegCo in the 2011-12 legislative session. This would allow time for the development of the necessary rules and codes of practice by the HKMA, and for necessary operational changes and system enhancements by AIs to prepare for the first phase of Basel III implementation in January 2013.

**Financial Services and the Treasury Bureau
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