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Urgent By Fax

23 February 2012

Legal Service Division
Legislative Council Secretariat
Legislative Council Complex,
1 Legislative Council Road,
Central
(Attn: Miss Wendy KAN)
(Fax: 2877 5029)

Dear Miss KAN,

Re: Banking (Amendment) Bill 2011 (the "Bill")

Thank you for your letter of 17 February 2012 with respect to the Bill, relaying a concern from a Member regarding the proposed use of rules made by the Monetary Authority ("MA") to prescribe capital and liquidity requirements for authorized institutions. The concern seems to emanate principally from the fact that, at present, these requirements are prescribed mainly by way of primary legislation whereas the rules will be subsidiary legislation, subject to negative vetting by the Legislative Council ("LegCo").

This letter sets out the reasoning for the proposed approach in the Bill by reference to the technical nature of the rules, the need to respond to international requirements in a timely manner, the standing practice for LegCo scrutiny as well as similar treatment in local and overseas legislation.

Technical Nature of the Rules

The regulatory capital framework for banks introduced by Basel 2 in 2007 set out a complex methodology, with a variety of options, for the calculation of a bank's capital adequacy ratio. The MA was granted rule-making powers in the Banking Ordinance ("BO") (Cap. 155) to prescribe the manner of calculation and the disclosure requirements in respect of authorized institutions' capital ratios and subsequently issued the Banking (Capital) Rules (Cap. 155L) and the Banking (Disclosure) Rules (Cap. 155M) for this purpose. Both sets of rules were amended through the negative vetting procedure in 2011, to implement the regulatory reform package, dubbed "Basel 2.5", promulgated by the Basel Committee on Banking Supervision ("BCBS").

The Basel 3 framework, which the Bill seeks to implement, is technically more complex than the Basel 2 minimum capital adequacy ratio and the existing liquidity ratio in the BO. It introduces three risk-weighted capital ratios, two capital buffers, a non-risk weighted leverage ratio and two liquidity ratios, some of which involve methodologies and computations that are significantly different from, and more complex than, the existing two ratios (capital and liquidity). The computational complexity of the ratios renders them ill suited for inclusion in the primary legislation and we see merit in including such ratios in rules alongside the accompanying methodologies for their calculation. We therefore propose in the Bill to build upon the MA's existing rule-making powers, which experience shows to have worked effectively, to enable the MA to prescribe capital and liquidity requirements for the purpose of ensuring that authorized institutions maintain adequate capital and liquidity resources consistent with what are sound and prudent, taking into account the risks they run.

Need for Timely Responses to International Requirements and Changing Market Circumstances

The move from Basel 2 (with its single total risk-weighted capital ratio) to Basel 3 (with its three risk-weighted capital ratios, two capital buffers, non-risk weighted leverage ratio and two liquidity ratios), within a short timeframe in the context of regulatory development, reflects the need for regulation and regulatory requirements to keep pace with rapid evolution in markets, products and banks' business models. This pattern can be expected to continue in future and we must ensure that our regulatory framework is swiftly responsive and capable of being adapted (both in terms of the level of capital and liquidity resources to be maintained and the underlying calculation methodologies) to new situations and new requirements expeditiously.

Internationally, it is fair to say that there is now much greater expectation of timely implementation of international standards by individual jurisdictions at the national level. This is due to fears of contagion arising from global interconnectedness and to regulatory arbitrage as well as level playing field concerns (i.e. that jurisdictions with lower regulatory standards might attract business (potentially undesirable business) on that basis). Thus in the past couple of years, we have seen the BCBS and the Financial Stability Board conducting a range of "assessments" (essentially peer reviews) on member jurisdictions. The BCBS has already begun several levels of assessment of its member jurisdictions' Basel 3 compliance. Failure to comply in a timely fashion may lead to "naming and shaming" and jeopardise our continued participation in these standard-setting bodies – which would inevitably have significant adverse ramifications for Hong Kong's position as an international financial centre.

Subsidiary Legislation Subject to Consultation and LegCo Scrutiny

The proposed use of subsidiary legislation to prescribe the capital and liquidity requirements for authorized institutions will be subject to the same checks and balances as are currently applicable in the case of the existing Banking (Capital) Rules and Banking (Disclosure) Rules. The proposed rules for the implementation of Basel 3 will only be made by the MA after consultation with the industry. Also, in line with the established practice, we will brief and consult the relevant LegCo Panel on the draft rules before tabling them at LegCo for negative vetting.

The negative vetting procedure allows for consideration by LegCo in an effective and expeditious manner and should enable us to comply with international timelines. It provides the most appropriate balance in terms of satisfying the need for scrutiny and due process against the need for flexibility and timely responsiveness in regulation.

As we see it, legislative time is at a premium. The time required for the passage of primary legislation is, generally speaking, expected to be considerably longer than that required for negatively vetted subsidiary legislation. In view of the lessons we have recently learned regarding the need for making timely regulatory requirements in line with international standards and in order to ensure that our regulatory system can keep pace with other financial centres, we are of the view that negatively vetted subsidiary legislation provides the most appropriate means for the introduction of Basel 3 in Hong Kong.

Hong Kong Legislation

In Hong Kong, probably the closest analogue to the proposed capital and liquidity requirements are the Financial Resources Rules of the Securities and Futures Commission. Under section 145 of the Securities and Futures Ordinance (Cap. 571) -

"(1) The Commission may, after consultation with the Financial Secretary, make rules requiring licensed corporations to maintain such financial resources as are specified in the rules.

(2) Without limiting the generality of subsection (1) and without prejudice to section 398(7) and (8), the Commission may in the rules referred to in subsection (1) –

(a) require licensed corporations to maintain financial resources in accordance with –

(i) specified requirements as to the amount in which they are to be maintained; and
(ii) any other specified requirements;"

The Securities and Futures (Financial Resources) Rules (Cap. 571N), which are subject to negative vetting by LegCo, then set out the requirements applicable to licensed corporations, including the levels of liquid capital to be maintained as well as the calculation methodologies.

In the other principal financial sector, namely, insurance, it is the case that negatively vetted subsidiary legislation is used to specify percentages and calculation methodologies for, for example, the calculation of the required margin of solvency for long term business (see section 4 of Insurance Companies (Margin of Solvency) Regulation (Cap. 41F)).

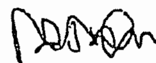
Overseas Legislation

We attach, at **Annex**, a table setting out the approaches to implementing capital and liquidity requirements for banks in a number of financial centres and other jurisdictions with a common law background similar to that of Hong Kong. As you will see, *none of the jurisdictions in the table include capital and liquidity ratios in their primary legislation, one includes the relevant provisions in prudential guidelines subject to negative vetting and a considerable number include the provisions in some form of supervisory or administrative notice which is not subject to parliamentary vetting.*

In summary then, in view of the various considerations outlined above and the range of both local and international practices, we are seeking in the Bill to build upon the MA's existing rule-making powers, which have operated well to date, in order to create a sufficiently responsive and balanced regulatory structure that accommodates both industry consultation and legislative scrutiny but also allows our system to be relatively "fleet of foot" in seeking to address the potential issues arising from increasingly rapid changes in the banking sector.

We trust the above will be of assistance in further explaining our policy considerations. If you, or the Member, require any further information, please feel free to contact us.

Yours sincerely,



(Miss Natalie LI)
for Secretary for Financial Services and the Treasury

c.c. HKMA (Attn: Ms Karen KEMP) (Fax: 2878 1670)
DoJ (Attn: Mr Michael LAM
Miss Mandy NG) (Fax: 2869 1302)
Clerk to House Committee

Annex

Implementation approach of Basel 3 in other jurisdictions

Jurisdiction	Australia	Canada	Japan	New Zealand	Singapore	US	UK
Instrument for implementation	Prudential Standards	Guidelines	Administrative Notices	Prudential Standards	Notices	Codes of Federal Regulations	Rules
Issuer	Australian Prudential Regulation Authority pursuant to section 11AF of the Banking Act	Office of the Superintendent of Financial Institutions ("OSFI")	Financial Services Agency under the Banking Act	Reserve Bank of New Zealand under the Reserve Bank of New Zealand Act	Monetary Authority of Singapore pursuant to power under section 55 of the Banking Act	Administrative agencies (i.e. Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Federal Reserve)	Financial Services Authority issued under Part 10 (section 138 et seq.) of the Financial Services and Markets Act
Primary legislation	No	No	No	No	No	No	No
Parliamentary scrutiny	Yes	No	No	No	No	No	No

Jurisdiction	Australia	Canada	Japan	New Zealand	Singapore	US	UK
Remarks	Standards are legally binding and subject to 10 days negative vetting by Parliament	Guidelines used for the purpose are not legally binding and do not go through the Parliament. OSFI also have power under section 485(1) of the Bank Act to issue binding guidelines but this power is not used for the purpose.	Administrative Notices are legally binding but not conditional upon approval by the Parliament	Standards are legally binding but are not required to go through the Parliament	Notices impose legally binding requirements on a specific class of financial institutions or persons	Codes of Federal Regulations are legally binding and are not required to go through Congress	Rules have equivalent effect to secondary instruments but do not go through the Parliament