CB(1)2094/11-12(02)

Legislative Council
Panel on Financial Affairs
4 June 2012

Progress in Implementation of Basel III Standards in Hong Kong

Hong Kong Monetary Authority

Basel Capital Framework

- Pillar 1 : Quantitative calculation of regulatory capital for credit, market and operational risk

$$\text{CAR} = \frac{\text{Capital base}}{\text{Risk-weighted assets}} \geq 8\%$$

- Pillar 2 : Banks' capital adequacy assessment process + supervisors' supervisory review process

- Pillar 3 : Market discipline – disclosure

Why Basel III?

Global Financial Crisis demonstrated: -

- Quality & level of capital not sufficient to absorb losses on going concern basis
- Cyclicality of regulatory capital framework
- Inadequate counterparty credit risk coverage within regulatory capital framework
- Liquidity risk management deficiencies

Basel III - Simpler Capital Structure

New (2 tiers):

- Tier 1 (CET1 + AT1) = 6%
  - CET1 = 4.5%
- Tier 2
- Total CAR = 8%

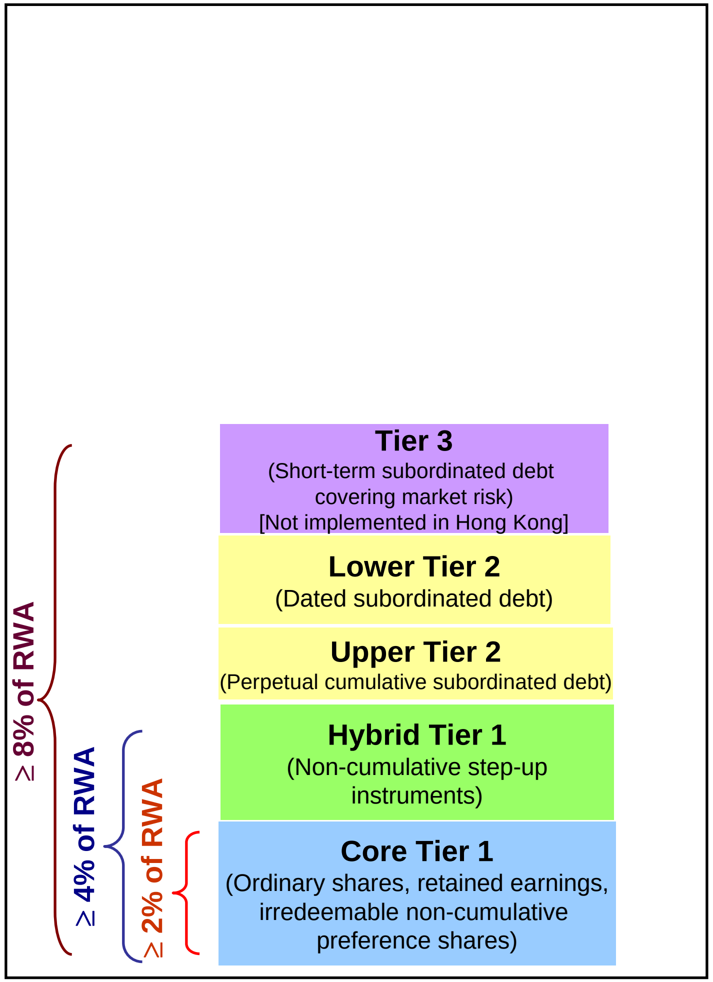
Old (3 tiers):

- Tier 1 = 4%
  - Core Tier 1 = 2%
- Tier 2 (upper and lower)
- Tier 3 (short-term)
- Total CAR = 8%

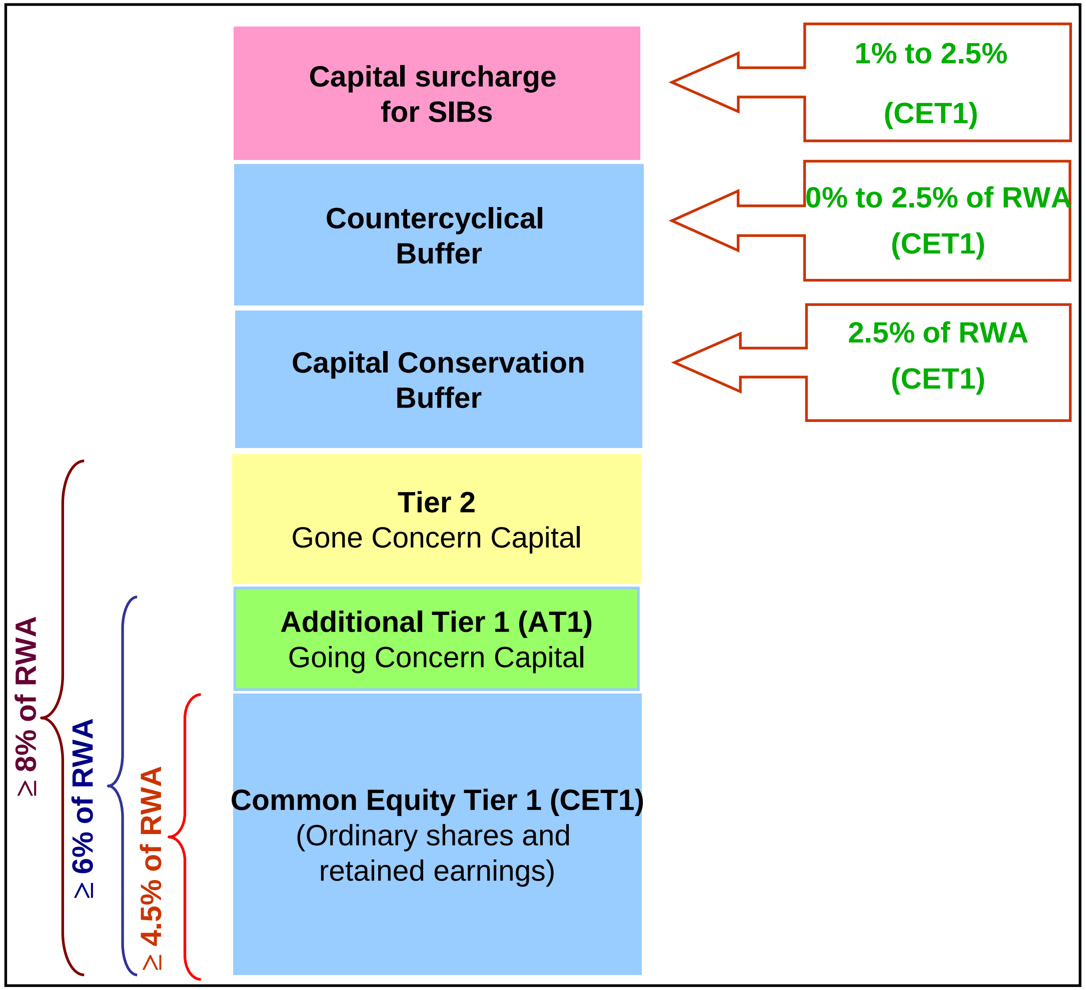
➢ **Stricter entry criteria for capital instruments**

Definition of Capital

Basel II (Current)



Basel III (Future)



Harmonised Regulatory Adjustments (1)

- **Contingent items** that ultimately may not provide loss absorbent capital to the extent of accounting value:

  1. Goodwill & other intangibles
  2. Deferred tax assets
  3. Shortfall of provisions to expected losses
  4. Gain on sale related to securitizations
  5. Defined benefit pension fund assets

➢ **Deducted from CET1**

Harmonised Regulatory Adjustments (2)

- **Double-gearing items** that inflate regulatory capital within financial system

1. Investments in own capital instruments
2. Reciprocal cross holdings in capital of financial institutions (FIs)
3. Investments in capital of FIs outside scope of regulatory capital consolidation

➢ **Deducted on a "corresponding deduction approach" subject to concessionary thresholds**

Enhanced Disclosure

- Breakdown of regulatory capital
- Full reconciliation of constituents of regulatory capital to published financial statements
- Main features of each capital instrument (full terms and conditions on website)
- Explanation of any disclosed “non-regulatory ratios”

Restriction on Minority Interest Recognition

- More restrictive recognition of minority interest ("MI") in banks' consolidated capital base:
  - Include only MI in subsidiaries which are banking institutions
  - Exclude "surplus capital" attributed to minority shareholders
- 5 year phase-out for MI not eligible under Basel III

Enhanced Counterparty Credit Risk Coverage

- Stressed inputs into calculation methodology
- New capital charges for credit valuation adjustment (CVA) losses
- Strengthened risk management standards
- Lower risk weights for certain exposures to central counterparties
- Higher capital charges for (i) exposures to large FIs to reflect correlation and inter-connectedness and (ii) “wrong-way risk”

Capital Buffers

- **Conservation buffer**
  - 2.5% CET1 to ensure capital remains available to support business in periods of stress
- **Countercyclical buffer**
  - Up to 2.5% CET1 to build additional capital defences in periods of excessive credit growth associated with build-up of system-wide risk
- Capital distribution constraints when capital levels fall within buffer range

Limiting Excessive Leverage

- Supplementing CAR with a non-risk-based leverage ratio
  - Tier 1 capital: total on-balance-sheet assets and off-balance sheet exposures
  - Safeguard against potential error in risk-based measures
  - Testing minimum of 3%

Setting Global Liquidity Standards

- Qualitative - Sound Liquidity Risk Management Principles (2008)

- Quantitative:

  – Liquidity Coverage Ratio (LCR): to promote short-term liquidity resilience

  – Net Stable Funding Ratio (NSFR): to encourage more stable funding structures

Progress on Implementation

- Banking (Amendment) Ordinance 2012 - MA empowered to prescribe rules
- Policy proposals for rules being formulated in consultation with industry
- 1st consultative package on:
  - Capital requirements (taking effect from Jan 2013)
  - Preliminary proposals on liquidity requirements

Consultation Process (1)

- Basel III is minimum standard
- HKMA consulted industry on few specific areas where apparent justifications exist for going beyond Basel III
- Industry submissions addressed these and other areas
- HKMA taken on board industry's concerns in some areas and maintained original stance on others

Consultation Process (2)

Acceptance of industry submissions

- Double gearing (in respect of investments in capital of FIs outside regulatory scope of consolidation):
  - Basel III allows exemption from capital deduction up to a threshold level of 10% of CET1
  - HKMA initially proposed full deduction to eliminate double gearing and for simplicity but sought industry comments on impact on business activities
  - In light of industry concerns and, having regard to approaches in other jurisdictions, HKMA now proposes to make threshold available in accordance with Basel III

Consultation Process (3)

- Phase-in for deductions from CET1 (for items currently subject to deduction equally from Core and Supplementary Capital)
  - Basel III provides 5 year phase-in for deductions from capital (including from CET1)
  - HKMA initially proposed to make phase-in available only for “new” deductions under Basel III
  - Industry requested phase-in for “transfer” of existing 50/50 deductions to CET1 deductions to assist capital planning
  - HKMA is agreeable to instituting phase-in arrangement to facilitate smooth transition

Consultation Process (4)

Phase-in of regulatory adjustments

	2013	2014	2015	2016	2017	2018
Portion deducted from CET1	0%	20%	40%	60%	80%	100%
Remaining portion	100%	80%	60%	40%	20%	0%
deducted from :						
Tier 1	*50%*	*40%*	*30%*	*20%*	*10%*	*0%*
Tier 2	*50%*	*40%*	*30%*	*20%*	*10%*	*0%*

Consultation Process (5)

- Unrealized gains on fair-valued loans & receivables:
  - Basel III generally allows unrealized gains from assets to be included in CET1 capital
  - Financial instruments: HKMA originally proposed to allow such treatment for fair-valued securities but not for loans & receivables considering they were mainly held for interest income
  - Industry submission addressed intention to hold for capital gain on disposal, the use of prudential valuation guidance and the asymmetric treatment for those hedged with derivatives
  - HKMA is agreeable to aligning treatment of fair valued loans & receivables with that for fair valued securities

Consultation Process (6)

Maintenance of original stance

- Unrealized gains on revaluation of real property
  - Basel III generally allows unrealized gains from assets to be included in CET1 capital
  - Real property: HKMA proposed to
    - limit recognition to 45% of such gains
    - allow recognition only in Tier 2

    in view of volatility of local property market and potential implications of over-reliance on property revaluation to meet CET1 ratio
  - Industry noted valuation and audit requirements for inclusion in financial statements, with different views as to level of inclusion of gains in capital base
  - HKMA retains concerns re volatility and over-reliance and proposes to allow only limited recognition in Tier 2

Consultation Process (7)

- Exclusion of deferred tax assets (DTAs) and mortgage servicing rights (MSRs) from CET1
  - Basel III allows exemption from capital deduction for each of these items, up to a threshold level of 10% of CET1
  - HKMA proposed not to make threshold available – due to concerns re genuine loss-absorption capacity
  - Industry noted level-playing field concerns
  - HKMA retains its original concerns but is prepared to hear further views from industry on loss-absorption capacity of DTAs and MSRs

Consultation Process (8)

- Incorporation of <u>“anti-avoidance” provision</u>
  - HKMA sought views from the industry on a mechanism to allow credit exposures to financial entities “akin” to investments to be subject to deduction
  - Industry submitted that credit exposures would not create “double-gearing” and rolled-over exposures are not necessarily indicative of capital investments
  - HKMA remains concerned that such exposures represent committed long-term resources to cover risks of borrowing entities and intends to include, but circumscribe, a provision applicable only to “connected entities” (similar to existing framework) which will not apply where banks can demonstrate credit exposures are incurred in the ordinary course of business

Consultation Process (9)

No uniform treatment under Basel III

- Integration of Pillar 2
  - Basel III does not explicitly address integration of Pillar 2 with new Pillar 1 requirements
  - HKMA proposed to retain existing Pillar 2 capital "add-on" to address non-Pillar 1 risks and apportion add-on among the three new minimum capital ratios
  - Industry raised concerns including (i) overlap between Pillar 2 add-on and new capital buffer requirements, (ii) comparative disadvantage vis-à-vis other jurisdictions not adopting the same approach
  - HKMA intends to retain Pillar 2 add-on as part of minimum requirements and has undertaken to review Pillar 2 process to identify any overlap with buffers

Consultation Process (10)

- Qualifying Central Counterparties ("QCCP")
  - AIs' exposures to QCCPs require less capital than exposures to non-QCCPs
  - Basel approach to determining whether a CCP is a QCCP:
    - CCP-regulator may disclose that CCP is qualifying based on specified criteria
    - if not, banks perform own due diligence
  - Industry requested a list of QCCPs (i.e. a "regulator-led" approach)
  - Issue not unique to Hong Kong. Developments on-going internationally

Work plan in 2012

- Next consultative package to be released shortly covering:
  - Disclosure standards associated with first phase of capital requirements
  - Aspects of liquidity standards
- Statutory consultation on draft Banking (Capital) (Amendment) Rules and Banking (Disclosure) (Amendment) Rules in Q3
- Draft rules tabled before LegCo for negative vetting in Q4

Impact of New Capital Requirements

- Hong Kong banks generally well-positioned to adopt Basel III capital standards:
  - Common equity is predominant element of capital base
  - Most of the harmonised regulatory adjustments already applied
  - Comfortable average T1 and CAR – 12.6% & 15.9% as at end-March 2012
  - 6 year transitional arrangements to facilitate capital planning

Overseas Implementation Approaches

	MINIMUM RATIO REQUIREMENTS				BUFFER REQUIREMENTS	
	Common Equity Tier 1 ratio	Tier 1 capital ratio	Total capital ratio	Implementation timeline	Capital conservation buffer	Implementation timeline
BCBS	4.5%	6.0%	8.0%	Gradual from 2013 to 2015	2.5%	Gradual from 2016 to 2019
Australia	4.5%	6.0%	8.0%	In full from 2013	2.5%	In full from 2016
Mainland China	5.0%	6.0%	8.0%	National SIB from 2013 Others from 2016	2.5%	National SIB from 2013 Others from 2016
European Union	[4.5%]	[6.0%]	[8.0%]	Gradual from 2013 to 2015	2.5%	Gradual from 2016 to 2019
Hong Kong	4.5%	6.0%	8.0%	Gradual from 2013 to 2015	2.5%	Gradual from 2016 to 2019
India	4.5%	6.0%	9.0%	In full from 2013	2.5%	Gradual from 2015 to 2018
	5.5%	7.0%	9.0%	Gradual from 2013 to 2015		
Japan	4.5%	6.0%	8.0%	Gradual from 2013 to 2015	2.5%	Gradual from 2016 to 2019
New Zealand	4.5%	6.0%	8.0%	In full from 2013	2.5%	In full from 2014
Singapore	4.5%	6.0%	8.0%	In full from 2013	2.5%	Gradual from 2016 to 2019
	6.5%	8.0%	10.0%	Gradual from 2013 to 2015		
United States	Draft regulation anticipated to be issued for consultation during Q2/2012					

Peer Review Process for Basel III

- **Level 1 assessments**
  - Timely adoption of Basel III
- **Level 2 assessments**
  - Consistency of local regulations with Basel III standards
- **Level 3 assessments**
  - Consistency of outcome of implementation across jurisdictions
  - Study on calculation of RWAs

Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012

- To specify Multilateral Investment Guarantee Agency ("MIGA") as multilateral development bank ("MDB") to align with the latest MDB list under Basel capital framework
- Exposures to MDBs receive preferential regulatory treatment (e.g. 0% risk-weight)
- MIGA (a member of the World Bank Group) encourages investment in developing countries by providing political risk insurance
- Industry consultation completed with positive response

End