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Paper for the House Committee meeting on 30 November 2012

Report of the Subcommittee on Banking (Capital) (Amendment) Rules 2012, Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 and Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012

Purpose

This paper reports on the deliberations of the Subcommittee on Banking (Capital) (Amendment) Rules 2012, Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 and Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012 ("the Subcommittee").

Background

2. Banking (Capital) (Amendment) Rules 2012 ("Capital Amendment Rules"), Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 ("MDB Amendment Notice") and Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012 ("BAO Commencement Notice") are three items of subsidiary legislation gazetted on 19 October 2012 for the first phase implementation of the revised regulatory capital standards (known as Basel III) promulgated by the Basel Committee on Banking Supervision[1] ("the Basel Committee").

[1] The Basel Committee sets the international standards in the field of banking supervision. Hong Kong joined the Committee as a member in June 2009.

3. The Basel Committee has previously designed regulatory frameworks commonly known as Basel I[2], Basel II[3] and Basel 2.5[4]. While Basel I and its subsequent amendments were implemented in Hong Kong through legislation under Part XVII of and the Third Schedule to the Banking Ordinance (Cap. 155) ("BO"), requirements under Basel II and Basel 2.5 frameworks were introduced in 2007 and 2012 respectively through the Banking (Capital) Rules (Cap. 155 sub. leg. L) and the Banking (Disclosure) Rules (Cap. 155 sub. leg. M) made by the Monetary Authority ("MA") and are subsidiary legislation subject to negative vetting of the Legislative Council ("LegCo").

4. Building upon Basel 2.5, Basel III is a package of regulatory capital and liquidity standards designed to further enhance the resilience of banks and banking systems and address weaknesses observed in the global financial crisis in recent years. Basel III seeks to improve the banking sector's ability to absorb shocks arising from financial and economic stress, and to reduce the risks of any spillover from the banking sector to the real economy. The Basel III capital standards increase the level, quality and transparency of banks' capital base, as well as the risk coverage of the capital framework.

5. The LegCo enacted the Banking (Amendment) Ordinance 2012 ("BAO") on 29 February 2012 to provide for the legal framework for implementation of Basel III in Hong Kong[5].

The Three Items of Subsidiary Legislation

<u>BAO Commencement Notice</u>

6. BAO Commencement Notice has been made by the Secretary for Financial Services and the Treasury under section 1(2) of BAO to appoint 1 January 2013 as the day on which certain provisions of BAO will come into operation. These BAO provisions amend the powers of MA to make rules to prescribe capital requirements for authorized institutions ("AIs") in Hong Kong and disclosure requirements[6] for AIs, confer powers on MA to approve codes of

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2 Basel I refers to the supervisory approach stipulated in the Basel Capital Accord adopted in 1988. A key element is the introduction of the capital adequacy ratio.

3 Basel II refers to the supervisory approach stipulated in the New Basel Capital Accord published in 2004 to replace Basel I.

4 Basel 2.5 refers to a set of enhancements to the Basel II framework issued by the Basel Committee in 2009.

5 The Administration introduced the Banking (Amendment) Bill 2011 into LegCo on 21 December 2011. No Bills Committee has been formed for scrutiny of the Bill.

6 According to the Administration, MA intends to make the Banking (Disclosure) (Amendment) Rules 2013, in the form of subsidiary legislation, in the first quarter of 2013 to prescribe the disclosure requirements associated with the new capital requirements. The relevant disclosure requirements will take effect from 30 June 2013 in order to align with the latest implementation timetable promulgated by the Basel Committee.

practice to provide guidance in respect of those rules; prescribe the procedure for remedial action to be taken by an AI which has contravened the requirements; and provide for the Banking Review Tribunal to review certain decisions made by MA in this connection.

The Capital Amendment Rules

7. The Capital Amendment Rules, which have been made by MA under section 97C of BO as amended by BAO, amend the Banking (Capital) Rules for implementation of the Basel III capital requirements. Amendments include revisions to the minimum capital ratio requirements and the definition of regulatory capital, enhancements to the counterparty credit risk framework, and other technical amendments. The major amendments cover the following:

(a) Setting three minimum risk-weighted capital ratios-

(i) Tier 1 capital is set at a minimum of 6%, comprising Common Equity Tier 1 ("CET1", principally ordinary shares, retained earnings and reserves) of at least 4.5% of risk-weighted assets, and Additional Tier 1 ("AT1", covering non-cumulative preference shares and perpetual subordinated debt instruments);

(ii) Tier 2 capital is supplementary capital covering cumulative preference shares and dated subordinated debt instruments; and

(iii) total capital (combining both Tiers 1 and 2) must be at least 8% of risk-weighted assets, which is the same as the current requirement prescribed under BO.

(b) Tightening the criteria for instruments to qualify for inclusion in the capital base to ensure that capital instruments are genuinely loss-absorbing. In particular, both AT1 and Tier 2 capital instruments are required to be capable of being converted into ordinary shares or written off at a point when the relevant regulatory authority determines the issuing banks to be non-viable.

(c) Restricting recognition of minority interest (i.e. capital issued by banks' consolidated subsidiaries and held by third parties) in banks' consolidated capital base. It also harmonizes the deductions and exclusions for determining the regulatory capital base, and requires these to be applied mostly to CET1 capital.

(d) Enhancing the risk coverage of the capital framework (i.e. the risk-weighted asset measure in the calculation of the regulatory capital ratios), by introducing measures to strengthen the capital requirements for counterparty credit risk.

The Capital Amendment Rules will come into operation on 1 January 2013.

MDB Amendment Notice

8. According to the Administration, the Basel Committee made a decision in May 2010 to include the Multilateral Investment Guarantee Agency ("MIGA"), which is a member of the World Bank Group, in the list of "multilateral development banks"[7] for the purposes of the Basel capital framework. MDB Amendment Notice has been made by MA to update the list of "multilateral development banks" in the Banking (Specification of Multilateral Development Bank) Notice (Cap. 155 sub. leg. N) to reflect the above decision of the Basel Committee, so that supervisors may allow banks to apply a 0% risk-weight to claims on MIGA. MDB Amendment Notice will come into operation on 1 January 2013.

The Subcommittee

9. At the House Committee meeting held on 26 October 2012, Members agreed to form a subcommittee to study the three items of subsidiary legislation. The membership list of the Subcommittee is in **Appendix I**. Under the chairmanship of Hon NG Leung-sing, the Subcommittee held two meetings and received written views from four organizations, the list of which is in **Appendix II**.

Deliberations of the Subcommittee

10. The Subcommittee supports the three items of subsidiary legislation which are designed to cater for the implementation of the first phase of Basel III requirements in Hong Kong with a view to strengthening the capital bases of AIs and enabling Hong Kong to follow fully with the Basel Committee's

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[7] Under section 2(19) of BO, MA may by notice published in the Gazette specify to be a multilateral development bank for the purposes of BO any bank or lending or development body established by agreement between, or guaranteed by, two or more countries, territories or international organizations other than for purely commercial purposes. Exposures to multilateral development banks will be treated more favourably for the purposes of calculating the capital adequacy ratio and liquidity ratio of an AI under BO and the Banking (Capital) Rules.

implementation timeline to underpin its status as a major international financial centre. The major deliberations of the Subcommittee are set out in the ensuing paragraphs.

<u>The Capital Amendment Rules and their impact on banks in Hong Kong</u>

11. While the Subcommittee notes the benefits of implementing Basel III to increase the level, quality and transparency of banks' capital base, as well as the risk coverage of the capital framework, some members including, Hon James TIEN and Hon SIN Chung-kai, are concerned about the impacts, in particular, on the borrowing costs of the banking sector and the general business, whether it will be necessary for AIs to raise capital in order to fulfil the Basel III requirements, and whether AIs will become more prudent in lending which may cause difficulty for the small and medium enterprises ("SMEs") and members of the public in obtaining credit.

12. The Hong Kong Monetary Authority ("HKMA") has advised that while the cost implications for compliance with the Basel III standards vary for different AIs as the compositions of their capital base and asset portfolio vary, it does not envisage that implementation of the new minimum capital adequacy ratios will increase the cost of borrowing for AIs because their capital adequacy ratio, in general, has been maintained at a very high level. As at the end of June 2012, the capital adequacy ratio for AIs stood at 15.9% which well exceeded the statutory requirement of 8%, and with a Tier 1 ratio of 13%. Moreover, a transitional period will be provided for AIs to comply with the successive increases in the minimum capital adequacy ratio from 2013 to 2015. Hence, AIs in Hong Kong should have no difficulty in fulfilling the new capital requirements of the first phase of Basel III implementation and large-scale capital-raising activities for AIs to meet the new requirements is not envisaged. While a number of AIs may need to adjust their capital mixes in response to the new ratios on capital requirements, no problem is envisaged for such AIs in the process.

13. As regards the impact on AIs' lending, HKMA has pointed out that this is affected by a host of other factors besides capital requirement on banks. Given that AIs in Hong Kong have been well-capitalized, implementation of the new minimum capital adequacy ratios should not adversely affect AIs' lending to SMEs, and hence the borrowing cost for the general business, as well as members of the public. On the other hand, implementation of the Basel III requirements will further enhance the resilience of AIs, enabling them to continue lending during periods of economic downturn.

14. Hon NG Leung-sing has conveyed the views of the banking sector to the Subcommittee that implementation of Basel III capital requirements will have no adverse impact on the banking sector in respect of costs and lending of AIs in the short and medium term, while some international banks may need to raise capital to fulfil the Basel III requirements in the long run.

15. The Subcommittee has enquired about the consultation with the Hong Kong banking sector on the first phase implementation of Basel III requirements. The Administration has advised that under section 97C of BO, MA is required to consult the Financial Secretary, the Banking Advisory Committee ("BAC"), the Deposit-taking Companies Advisory Committee ("DTCAC"), The Hong Kong Association of Banks ("HKAB") and The DTC Association on proposed changes to the Banking (Capital) Rules. To this end, HKMA conducted general industry consultations on the detailed proposals to be included in the Capital Amendment Rules in early 2012 (in respect of revisions to the minimum capital requirements and the definition of regulatory capital) and in the middle of 2012 (in respect of enhancements to the counterparty credit risk framework), and the text of the draft Capital Amendment Rules were provided for comments by the relevant banking organizations in August and September 2012. The organizations have indicated support for the direction of the amendments. Their views and comments on the draft Capital Amendment Rules have been taken into account in finalizing the rules.

16. The Subcommittee has invited written views from the relevant banking organizations on the implementation of Basel III requirements in Hong Kong. Members note that members of BAC and DTCAC have highlighted the importance of Basel III implementation for enhancing the ability of the Hong Kong banking system to withstand external and internal shocks, and the need to follow the Basel Committee's implementation timeline in reinforcing the strategic position of Hong Kong as a stable international financial centre with a strong capitalized banking system. BAC and DTCAC members have made a couple of recommendations on the draft Captial Amendment Rules, including introducing a minimum capital ratio requirement that varies among AIs according to their size and systemic importance in order to avoid excessive costs, and a more open approach to approval for institutions' adoption of risk models and systems employed by their overseas offices. HKAB has expressed support of the principles of adopting Basel III standards in Hong Kong. It believes that there will be no material impact on the banking sector but points out that the actual impact may vary between different AIs according to their individual circumstances, such as size, financial position, business nature and group structure. HKAB considers HKMA's consultation on the draft Capital Amendment Rules extensive and confirms that views and concerns expressed

during the consultation process have been taken into account. The DTC Association confirms that HKMA has consulted the industry on the critical issues relating to implementation of Basel III requirements in Hong Kong.

Modifications in the Capital Amendment Rules as Compared with the Basel Committee's Basel III Text

17. Given that the Basel III standards are global standards promulgated by the Basel Committee to be complied by banks in various jurisdictions, members have enquired about the differences, if any, between the Basel III capital requirements and the Capital Amendment Rules. HKMA has advised that Hong Kong needs to comply with the requirements set in the relevant policy papers issued by the Basel Committee, which contain technical standards and rules to be adopted by all jurisdictions implementing Basel III. Thus the Capital Amendment Rules are similar in substance to the comparable legislation of other jurisdictions for implementing Basel III. The Administration has also advised that in the course of drafting the Capital Amendment Rules, the Department of Justice has examined whether there will be conflict between the proposed rules and existing local legislation, and has made modifications as necessary to maintain consistency in the relevant provisions. However, HKMA has further explained that as the Basel III capital framework sets the minimum standards, the Basel Committee has allowed domestic supervisors to adopt adjustments or make modifications to the standards to address their specific circumstances, domestic concerns and prudential issues. The major modifications made in the Capital Amendment Rules relate to the treatment of unrealized gains on property revaluation; deferred tax assets and mortgage servicing rights; the incorporation of certain anti-avoidance provisions; and a couple of technical adjustments concerning the application of the standardized credit valuation adjustment risk capital charge under the enhanced counterparty credit risk framework. The Administration has briefed members on these modifications and explained the reasons for introducing them. The Subcommittee has examined the relevant rules. Members note that the modifications are necessary to cater for the unique circumstances of AIs in Hong Kong and the banking sector has been consulted on the issues involved.

18. In respect of the modification on the treatment of unrealized gains on property revaluation, members have enquired about the rationale for introducing the modification which only allows unrealized gains on property revaluation of AIs to be recognized in Tier 2 capital with the application of a 55% haircut whereas the Basel III requirements generally allow unrealized gains recognized on the balance sheet of banks to be included in the determination of CET1 capital. HKMA has explained that although the banking sector prefers to follow the Basel III requirement, HKMA remains concerned about the historical

volatility in the prices of property in Hong Kong whether held for own-use or investment by AIs. For some AIs, such gains could amount to a sizeable portion of their CET1 capital. Hence, allowing property revaluation gains into the CET1 capital of AIs will introduce an element of significant volatility into their CET1 ratios that could have a potentially adverse effect on their ability to support and continue their lending activities which could in turn have an adverse spill-over effect on the real economy. HKMA considers that even with the 55% haircut, there would still be concern from a prudential supervisory perspective for significant portions of AIs' CET1 capital to be constituted by unrealized gains on property revaluation. As the CET1 ratio will likely become the key measure of an AI's financial strength, CET1 capital should be constituted by genuinely available, readily loss-absorbing capital.

19. On whether there will be different treatment in capital requirements for local subsidiaries of overseas incorporated banks in the implementation of the Capital Amendment Rules, HKMA has advised that all AIs that are incorporated in Hong Kong, including local subsidiaries of overseas incorporated banks, will be subject to the Capital Amendment Rules.

International timeline for implementation of Basel III and possible delay in the first phase of implementation in some jurisdictions

20. According to the Administration, Basel III was endorsed by the G20 Leaders in November 2010 and they are committed to implementing Basel III fully in line with the Basel Committee's transitional timeline, under which implementation will begin from 1 January 2013, with the standards being phased in over the subsequent six years to achieve full implementation by 1 January 2019.

21. The Subcommittee has examined the progress of other jurisdictions in implementing Basel III. Members note that while major jurisdictions like Japan, Singapore, Australia and the Mainland have already issued their final rules, the European Union ("EU") and the United States ("US") may experience some delay in the implementation timetable. Hon NG Leung-sing has pointed out that the Hong Kong banking sector is aware of the comments made by the Financial Services Authority ("FSA") of the United Kingdom ("UK") and the Federal Reserve of the US and relevant US financial regulators recently about delay in implementing the first phase of Basel III requirements on 1 January 2013, and some views from the banking industry that there is no apparent justification for Hong Kong to be among the first batch of jurisdictions in implementing Basel III in January 2013. Members including Hon Alan LEONG, Hon James TIEN, and Hon SIN Chung-kai are concerned that possible delay in other jurisdictions in implementing Basel III on 1 January 2013 may

cause competitive disadvantage to AIs in Hong Kong, and enquired whether HKMA will consider introducing flexibility in the implementation timetable in Hong Kong. The Subcommittee has also urged the Administration to work closely with industry bodies in the banking sector in monitoring further developments in other jurisdictions in the implementation of Basel III.

22. HKMA has advised that recognizing the importance of Basel III in strengthening the financial system, a number of jurisdictions (not only members of the Financial Stability Board or the Basel Committee, but also other non-member jurisdictions) are working towards implementation of the Basel III enhanced capital standards. As indicated in the Basel Committee's *Report to G20 Finance Ministers and Central Bank Governors on Basel III implementation* in October 2012, most of Hong Kong's peers in Asia, including Australia, Mainland China, India, Japan and Singapore, have already issued final rules for Basel III implementation. All of these jurisdictions, with the exception of Japan, will implement Basel III from 1 January 2013. In Japan's case, implementation will take effect from March 2013 to coincide with the fiscal year cycle for banks in Japan. In the case of Australia, the phase-in period for the new minimum regulatory capital ratios set by the Basel Committee will be curtailed. Australian banks will be expected to meet the new minimum ratios in full from 1 January 2013, as opposed to the ratio levels being progressively phased-in from January 2013 to January 2015. Similarly, in Singapore, the new minimum ratios must be met in full from 1 January 2013 (i.e. without phase-in), and the Monetary Authority of Singapore will require Singaporean banks to meet higher regulatory capital ratios than the minimum Basel III ratios (with such higher ratios being phased-in from 1 January 2014 to 1 January 2015). Elsewhere, Switzerland has issued its final rules for Basel III implementation to take effect from 1 January 2013. In the case of its two largest systemically important banks, higher minimum standards will be imposed over a transition period until 2018.

23. Regarding the situation in the EU, the Administration has advised that the Capital Requirements Directive ("CRD") IV package, which will implement Basel III in the EU, is currently under discussion among the European Parliament, the European Commission and the EU Council of Ministers. Whilst the original intention was to finalize an agreed position by end June 2012 to enable adoption by the European Parliament plenary in early July 2012, the present intention appears to be to reach an agreement by the end of 2012. Although CRD IV has not yet been adopted in final form, some jurisdictions in the EU, notably the UK and Germany, have taken preparatory action. The German government has issued a draft CRD IV Implementation Act, whereas in the UK, FSA has recently set out its proposed manner of implementation of

transitional provisions in CRD IV[8]. In terms of bank recapitalization to pave the way for transition to the CRD IV framework, the European Banking Authority ("EBA") has been conducting a "capital exercise" (a form of stress-testing) on 71 of Europe's largest banks. In December 2011, a temporary target ratio of 9% Core Tier 1 capital was set for those banks covered by the exercise to comply with from end June 2012. It now appears that this target will remain in force, and work is underway to map the 9% ratio which uses an EBA definition of capital to the CRD IV definition of capital.

24. As for the US, the US regulatory agencies issued three notices of proposed rulemaking covering Basel III in June 2012. The extended consultation period closed towards the end of October 2012, and the regulatory agencies are reported to be considering the submissions received. On 9 November 2012, the US regulatory agencies announced that they did not expect the proposed rules to become effective on January 1 2013 but re-iterated that they were working as expeditiously as possible to complete the rule-making process[9]. Notwithstanding that Basel III is not yet in force, the US regulatory agencies have been subjecting major banks and bank holding companies to annual stress-tests, with a view to ensuring that they are sufficiently well capitalized to continue operations during times of economic or financial stress. For instance, the 19 largest banking holding companies covered in the Federal Reserve Board's stress-testing programme are required to demonstrate the ability to maintain a minimum tier 1 common capital ratio of 5% over a minimum of 9 quarters under both baseline and stress scenarios used in the programme. This effectively means these banking holding companies must hold capital levels comparable to Basel III standards. Thus, with regard to the largest institutions, significant recapitalization has been occurring post-crisis and in the run-up to Basel III implementation.

25. Given the benefits of Basel III in bringing about a better capitalized and more resilient banking system for Hong Kong, the Basel Committee's determination to implement the first phase of Basel III standards on 1 January 2013[10], and the need for Hong Kong as a major international financial centre to align with the international implementation timetable, the Administration considers that Hong Kong should remain committed to implementing Basel III

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[8] The Basel Committee has conducted a Basel III Regulatory Consistency Assessment of the EU based on a CRD IV compromise proposal of May 2012 and a follow-up assessment will take place once the EU authorities publish the final rules text.

[9] Recently the US was the subject of a "Basel III Regulatory Consistency Assessment" by the Basel Committee. The assessment was made in respect of the three notices of proposed rulemaking and a follow-up assessment will take place once the US agencies have published the final rules to implement Basel III.

[10] In a communiqué issued by the G20 Finance Ministers and Central Bank Governors on 5 November 2012, the G20 Ministers and Governors reaffirmed that: "We agree to take the measures needed to ensure full, timely and effective implementation of Basel II, 2.5 and III and its consistency with the internationally agreed standards".

on 1 January 2013.

26. Noting the possible delay in the implementation timeline of Basel III in the EU and the US, and the views of HKAB that it is imperative that a level regulatory playing field is created and that the Basel III proposals are implemented globally, the Subcommittee has invited further views from HKAB on the implementation timetable for Hong Kong. Members note that HKAB has re-iterated the importance of creating a level regulatory playing field and implementing the Basel III proposals globally. HKAB has observed that while the timetable for the implementation of Basel III standards will vary across jurisdictions, the major jurisdictions across the globe are heading in the same direction over the longer term. It also believes that AIs in Hong Kong are prepared for the implementation of Basel III standards, and AIs are overall well capitalized and should not have issues in fulfilling the new minimum capital standards. On the timetable for Hong Kong, HKAB considers that by adopting Basel III standards from 1 January 2013, Hong Kong will reinforce its position as a leading financial centre, firstly by showing leadership in the implementation of the new standards, and also by giving AIs clarity and stability with regard to the regulatory environment and their capital requirements. HKAB points out that HKMA has undertaken to monitor Basel III implementation developments in other major jurisdictions, and the Association will continue to work closely with HKMA in this regard.

<u>Chinese renditions for banks and bodies specified in section 2 of the Banking (Specification of Multilateral Development Bank) Notice</u>

27. Noting that only the bank and body specified in section 2(c) and the proposed section 2(n) (to be made by MDB Amendment Notice) of the Banking (Specification of Multilateral Development Bank) Notice ("Notice") have Chinese renditions, members have enquired whether there are Chinese renditions for the banks and bodies specified in other subsections of section 2 of the Notice. The Administration has advised that while the current Chinese text of the Notice contains names of several multilateral development banks without Chinese rendition from the time when this subsidiary legislation was made and subsequently amended in the past, the legal effect and operation of the relevant provisions of the subsidiary legislation will not be affected. In response to members' request, the Administration is conducting a review of the relevant provisions, and where necessary will confirm with such multilateral development banks the proper and official Chinese names for these banks, if any. Subject to this review and confirmation, the Administration will introduce further legislative amendments to address this textual issue via a future Statute Law (Miscellaneous Provisions) Bill as appropriate.

Advice sought

28. The Subcommittee will not move any amendments to the three items of subsidiary legislation. Members are invited to note the deliberations of the Subcommittee.

Council Business Division 1
Legislative Council Secretariat
28 November 2012

Appendix I

Subcommittee on Banking (Capital) (Amendment) Rules 2012, Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 and Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012

Membership list

Chairman	Hon NG Leung-sing, SBS, JP
Members	Hon Abraham SHEK Lai-him, SBS, JP Hon Starry LEE Wai-king, JP Hon Alan LEONG Kah-kit, SC Hon James TIEN Pei-chun, GBS, JP Hon SIN Chung-kai, SBS, JP
	(Total：6 members)
Clerk	Ms Connie SZETO
Legal Adviser	Ms Wendy KAN

Appendix II

Subcommittee on Banking (Capital) (Amendment) Rules 2012, Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 and Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012

List of organizations that have given views to the Subcommittee

1. The Hong Kong Association of Banks
2. The DTC Association
3. The Banking Advisory Committee
4. The Deposit-taking Companies Advisory Committee