

For discussion
on 7 July 2014

Legislative Council Panel on Financial Affairs

Proposed Amendments to the Banking (Capital) Rules and Banking (Disclosure) Rules, and Enactment of the Banking (Liquidity) Rules, for Implementation of Basel III Standards in Hong Kong

PURPOSE

The Legislative Council (“LegCo”) enacted the Banking (Amendment) Ordinance 2012 in February 2012 to provide the legal framework for implementation in Hong Kong of the revised regulatory capital, disclosure and liquidity standards promulgated by the Basel Committee on Banking Supervision (“BCBS”) (known as “Basel III”). This paper seeks to update Members on –

- (a) the progress in respect of the implementation of the first phase of Basel III capital standards and the corresponding disclosure requirements which came into effect in 2013; and
- (b) the legislative timetable for the proposed subsidiary legislation required to implement the second phase of Basel III (covering capital, liquidity and disclosure requirements) with effect from 1 January 2015.

FIRST PHASE OF BASEL III IMPLEMENTATION

2. The Monetary Authority (“MA”)¹ has been empowered by the Banking Ordinance (Cap. 155), to make rules to prescribe capital, liquidity and disclosure requirements applicable to authorized institutions (“AIs”). To this end, the Banking (Capital) (Amendment) Rules 2012²

¹ In this paper, “MA” refers to “Monetary Authority” or “Hong Kong Monetary Authority”, as the context so requires.

² Further amendments to the Rules were made through the Banking (Capital) (Amendment) Rules 2013 to implement the technical guidance issued by the BCBS in December 2012 in relation to the counterparty credit risk framework and some miscellaneous refinements.

and the Banking (Disclosure) (Amendment) Rules 2013 came into operation on 1 January 2013 and 30 June 2013 respectively, to implement in Hong Kong the first phase of Basel III capital standards and the corresponding disclosure requirements.

3. In essence, the first phase of the Basel III capital standards has increased the minimum regulatory capital requirement, tightened the criteria for instruments to be recognised as regulatory capital, and enhanced the risk coverage of the capital framework for AIs incorporated in Hong Kong. The corresponding disclosure requirements have enhanced the consistency and comparability of AIs' disclosures in respect of their capital base.

4. The MA has been monitoring the implementation of the first phase of Basel III capital standards and the corresponding disclosure requirements in Hong Kong through its on-going supervisory process. This includes review of both quarterly banking returns submitted by relevant AIs on their capital positions, and of their capital planning in light of the Basel III requirements. The MA observes that the implementation process has been smooth. The aggregate capitalisation of Hong Kong's banking sector remains well above the Basel III minimum requirements³, with locally incorporated AIs' average Common Equity Tier 1 ("CET1") capital ratio and total capital ratio standing at 13.1% and 15.9% as at end-March 2014. The strong capitalisation and resilience of Hong Kong's banking sector has been reaffirmed by the International Monetary Fund in its recent assessment of Hong Kong.

SECOND PHASE OF BASEL III IMPLEMENTATION

5. The second phase of Basel III implementation covers the introduction of a series of capital buffers, a liquidity coverage ratio, and disclosure requirements arising from the capital buffers, liquidity coverage ratio and leverage ratio requirements⁴. These standards seek to

³ The Basel III minimum (Pillar 1) requirements are a Common Equity Tier 1 capital ratio of 4.5%, a Tier 1 capital ratio of 6% and a total capital ratio of 8% of risk-weighted assets respectively.

⁴ According to the BCBS implementation timetable, the disclosure requirements in relation to banks' leverage ratios will take effect from 1 January 2015, ahead of the leverage ratio becoming a minimum requirement on 1 January 2018.

enhance AIs' liquidity risk management and their ability to absorb shocks in times of financial and economic stress. The MA proposes amending the Banking (Capital) Rules (Cap. 155L) and the Banking (Disclosure) Rules (Cap. 155M), and making the Banking (Liquidity) Rules within this year, in order to implement in Hong Kong the second phase of the Basel III requirements which are scheduled to take effect from 1 January 2015 in accordance with the BCBS transitional timetable.

Capital standards

6. The MA proposes amending the Banking (Capital) Rules to implement the Basel III capital buffer requirements. These requirements seek to further bolster AIs' resilience in absorbing shocks arising from financial and economic stress, by incentivising AIs to build up and hold, outside of periods of stress, an additional layer of CET1 capital above their minimum capital requirements. AIs may draw upon these capital buffers to absorb losses, but they will be subject to restrictions on their ability to make discretionary distributions when their capital levels are within the "buffer zone". In summary, the Basel III capital buffer requirements consist of three components—

- (a) Capital conservation buffer – AIs incorporated in Hong Kong will need to hold an additional layer of CET1 capital, amounting to 2.5% of their total risk-weighted assets, in order to avoid distribution constraints. According to the BCBS transitional timetable, the capital conservation buffer will be phased-in in equal annual increments from 0.625% in January 2016 to 2.5% in January 2019.
- (b) Countercyclical capital buffer ("CCyB") – Under the Basel III framework, the relevant authority in each jurisdiction will put in place a jurisdictional CCyB requirement for any banks' private sector credit exposures in their jurisdiction when there is "excess aggregate credit growth associated with a build-up of system-wide risk" in their jurisdiction. The CCyB is "countercyclical" in nature as it will only be "switched on" or increased in a given jurisdiction in times of "credit boom" in response to excessive credit growth with systemic implications, and will be "switched off" or reduced when the credit cycle turns

down so that banks can rely on the available capital released from the CCyB to support continued lending to the real economy.

A jurisdictional CCyB rate⁵ will directly apply to banks incorporated in the relevant jurisdiction while, on a reciprocal basis, overseas authorities will impose a corresponding CCyB requirement on their banks in relation to their banks' credit exposures in the relevant jurisdiction. The MA proposes that, in addition to the capital conservation buffer, AIs which are subject to a CCyB will need to hold an additional layer of CET1 capital ranging normally between 0% and 2.5% of their risk-weighted assets in order to avoid distribution constraints. The CCyB requirement is calculated for each relevant AI by reference to the geographical location of its private sector credit exposures and the applicable jurisdictional CCyB rates. The CCyB's normal cap of 2.5% will be phased-in over a period of three years from 2016 to 2019 in equal annual increments.

Whilst the Basel III standard focuses on a jurisdictional CCyB normal range of 0% to 2.5%, the BCBS specifically allows relevant authorities to exercise discretion in setting a CCyB rate in excess of 2.5% if appropriate in light of local circumstances. As an international financial centre with a large banking sector and an open economy, Hong Kong is exposed to the risk of volatile capital flows and can be influenced significantly by international financial conditions. The MA is inclined to seek to preserve its flexibility in relation to setting a jurisdictional CCyB above 2.5% as a macroprudential tool to guard against severe systemic risks in extraordinary circumstances.

In order to give AIs sufficient time to adjust their capital planning, the MA proposes announcing in advance its decisions to switch on or increase the jurisdictional CCyB by a 12-month advance notice normally (or, in exceptional circumstances, a 6-month notice) before the requirement becomes effective. In

⁵ Jurisdictional CCyB rate refers to the CCyB rate announced by a jurisdiction in respect of banks' private sector credit exposures located in that jurisdiction.

contrast, any release or reduction of the CCyB will be expected to take effect immediately upon the announcement by the MA to reduce the risks of credit supply being unnecessarily constrained.

- (c) Higher loss absorbency requirement (“HLA requirement”) – The HLA requirement will apply to global or domestic systemically important banks (“G-SIBs” and “D-SIBs”) whose failure could have significant spillover externalities to the financial system and ultimately to the real economy. To avoid distribution constraints, G-SIBs and D-SIBs will be required to maintain an additional layer of CET1 capital ranging from 1% to 3.5%, depending on their perceived level of systemic importance, of their total risk-weighted assets, in excess of the minimum capital ratios and abovementioned buffer requirements. The HLA requirement will be phased-in over a period from 2016 to 2019 in equal annual increments.

At present, no local banking group headquartered in Hong Kong has been designated by the BCBS and the Financial Stability Board (“FSB”) as a G-SIB⁶. For the purpose of assessing D-SIBs, Hong Kong is expected to develop its own methodology based upon a principle-based framework published by the BCBS in 2012. For this purpose, the MA has consulted the industry regarding the adoption of a “bucketing approach” methodology (similar to that used internationally for assessing G-SIBs) which will allocate a “systemic score” to relevant AIs by reference to a set of factors and indicators⁷. This systemic score will determine the appropriate level of HLA requirement for an AI designated as a D-SIB reflecting the degree of systemic importance of these banks to the Hong Kong economy.

Liquidity standards

7. The MA proposes making the Banking (Liquidity) Rules to implement the Basel III Liquidity Coverage Ratio (“LCR”) requirement.

⁶ The BCBS and the FSB will conduct a designation exercise annually, with the updated list of G-SIBs being published by the FSB after the exercise is concluded.

⁷ There are five broad categories of indicators, to assess respectively a bank’s systemic importance in terms of its cross-jurisdictional activity, size, interconnectedness, substitutability, and complexity.

The LCR seeks to promote banks' short-term liquidity resilience by ensuring that they have sufficient high quality liquid assets ("HQLA") to meet their obligations for at least 30 days under an acute stress scenario⁸.

8. The MA intends to adopt a two-tiered approach to the application of the revised liquidity standards having regard to the diversity of AIs in Hong Kong in terms of their scale of operation and their significance to the local banking system. Under this approach, the new LCR will apply to internationally-active AIs, as well as those larger or more sophisticated AIs that are of greater significance to Hong Kong's banking sector. In parallel, a Liquidity Maintenance Ratio ("LMR") requirement, which will be a modified version of the existing liquidity ratio in the Banking Ordinance⁹, will apply to all other AIs with a lesser degree of operational sophistication or systemic importance to the banking sector.

9. The LCR and LMR will be implemented through the proposed Banking (Liquidity) Rules. The Administration will bring into force the relevant statutory provisions relating to the new liquidity requirements, as stipulated by the Banking (Amendment) Ordinance 2012, through a Commencement Notice.

Disclosure requirements

10. Following the approach adopted for implementing the first phase of Basel III, the MA will make amendments to the Banking (Disclosure) Rules to implement the consequential disclosure requirements arising from the capital buffer and liquidity requirements, and to introduce disclosure requirements in relation to AIs' leverage ratios. The MA will issue standard disclosure templates based upon those prescribed by the BCBS to facilitate the making of the relevant disclosures by AIs.

⁸ The LCR is a ratio, expressed as a percentage, of the total stock of HQLA held by a bank to its total net cash outflows over a period of 30 calendar days. The BCBS recommends a phased implementation of the LCR from 1 January 2015 with the minimum LCR requirement beginning at 60% initially, to be followed by annual increments of 10% points until the minimum requirement reaches 100% on 1 January 2019.

⁹ Pursuant to section 102 of and the Fourth Schedule to the Banking Ordinance, all AIs are subject to a minimum liquidity ratio of 25%. Accordingly, relevant AIs subject to the LMR requirement shall in future maintain liquefiable assets sufficient to cover at least 25% of their qualifying liabilities (after deductions of some prescribed cash inflows) due within one month.

INTERNATIONAL PRACTICE

11. As at end-March 2014, all BCBS member jurisdictions had commenced implementation of Basel III. Most BCBS members are making identifiable progress in relation to the implementation of the second phase of the Basel III standards. As a reputable international financial centre, Hong Kong will be expected to follow the BCBS timetable in taking forward the Basel III standards.

12. In relation to the capital buffer requirements, some jurisdictions (e.g. the United States (“US”), Australia, Singapore and the European Union (“EU”)¹⁰) have already provided a framework for the implementation of those requirements in their existing Basel III regulations. For the CCyB, some jurisdictions (e.g. the EU, Singapore, New Zealand and Norway) have opted not to set any upper limit on their jurisdictional CCyB for prudential considerations. Most jurisdictions are still contemplating their final HLA requirements for D-SIBs, while some (such as Australia, Denmark and the EU) have already set HLA requirements ranging from 1% to 3.5% of risk-weighted assets taking into account their local context.

13. In relation to the LCR, most BCBS member jurisdictions have been taking steps to implement the LCR from 1 January 2015. A few jurisdictions have already implemented the LCR (e.g. the Mainland of China) or have issued their final local regulations or guidelines (e.g. Australia). It is noted that, among other things, some jurisdictions differ in their approach to implementing the LCR phase-in arrangement¹¹.

¹⁰ The EU has approved the new Capital Requirements Directive (commonly referred to as “CRD IV”) which implements the capital buffer requirements, and its member states have issued, or will be issuing, regulations to transpose CRD IV into domestic regulations.

¹¹ For example, the US will phase-in the LCR from 2015 with the initial minimum requirement set at 80%, which will be steadily increased to 100% by 2017. In the Asian region, similar to Hong Kong, Singapore will adopt the BCBS phase-in timetable. Australia will not adopt the phase-in arrangement.

MARKET ENGAGEMENT AND CONSULTATION

14. The MA is engaging the banking sector intensively on an on-going basis (through industry wide consultation and discussions with individual AIs or industry groups) in respect of the implementation and the technical aspects of the abovementioned proposals. The MA has considered (and will continue to do so) the feedback of the industry carefully in developing and refining local regulatory requirements with reference to the standards promulgated by the BCBS and prevailing local circumstances. In particular-

- (a) in relation to the capital buffer requirements, the MA has consulted the industry on the method and indicators the MA proposes considering in assessing whether there is excess credit growth with systemic implications in Hong Kong;
- (b) in relation to the D-SIB-framework, the MA has consulted the industry on the proposed methodology and indicators for identifying D-SIBs, and the determination of the level of the corresponding HLA requirement (including its application to local subsidiaries of foreign banking groups); and
- (c) in relation to the liquidity standards, the MA has undertaken three rounds of consultation with the industry in the course of devising the detailed requirements for the adoption of a “two-tiered approach” in applying the standards, the phased implementation of the LCR, the scope of the HQLA to be included in the LCR, and the modifications to the existing liquidity ratio to produce the LMR.

IMPACT ASSESSMENT ON BANKS IN HONG KONG

15. The proposals for the second phase of Basel III implementation are consistent with the relevant Basel III standards. Given the strong capitalisation of the local banking sector, it is the MA’s assessment that the buffer proposals are not expected to have a significant impact on AIs’ capital positions. The phase-in arrangements for the second phase of the capital standards should provide sufficient time for any AIs, which need

to do so, to adjust their capital positions to meet the new requirements. With careful capital planning by AIs, which the MA will monitor through its on-going supervisory process, the proposals are not expected to have a significant impact on AIs' dividend policies in general.

16. In relation to the new liquidity standards, the MA expects that most AIs will likely be subject to the LMR, and only a relatively small number of larger, more sophisticated AIs will likely be subject to the LCR requirements. The adoption of a two-tiered approach should avoid imposing an undue compliance burden on AIs with a lesser degree of operational sophistication or systemic importance to the banking sector. The relevant quantitative impact studies conducted to date broadly indicate that AIs should not have any major difficulty in meeting the relevant liquidity requirements from 1 January 2015 onwards, and that some may need to fine-tune or adjust their liquidity or funding strategies as appropriate. The phase-in arrangements for the LCR should provide sufficient time for relevant AIs, which need to do so, to adjust their liquidity positions to meet the new requirements. The MA will continue to monitor the liquidity positions of the AIs closely and provide necessary guidance to facilitate their compliance with the new requirements.

LEGISLATIVE TIMETABLE

17. In light of the BCBS timetable, work is progressing to draft the subsidiary legislation to implement the second phase of Basel III. To this end, the MA intends to table before LegCo the Banking (Capital) (Amendment) Rules 2014, the Banking (Liquidity) Rules 2014, and the Banking (Disclosure) (Amendment) Rules 2014, for negative vetting in Q4/2014¹². Prior to this, the MA will undertake statutory consultations on the draft rules with the Financial Secretary, the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, The Hong Kong Association of Banks, and The DTC Association, in accordance with sections 97C, 97H and 60A of the Banking Ordinance. The MA's target is for the rules to come into operation on 1 January 2015.

¹² In tandem, the Secretary for Financial Services and the Treasury will designate 1 January 2015 as the date on which relevant provisions relating to Basel III liquidity amendments under the Banking (Amendment) Ordinance 2012 will commence operation, via a Commencement Notice which is also subject to negative vetting by LegCo.

ADVICE SOUGHT

18. Members are invited to note the progress of Basel III implementation in Hong Kong and the Administration's legislative plan as set out in this paper.

Financial Services and the Treasury Bureau
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