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**Legislative Council**

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**Panel on Financial Affairs**

**Meeting on 7 July 2014**

**Background brief on the implementation of Basel III in Hong Kong**

**Purpose**

This paper provides background information on the implementation of Basel III in Hong Kong. It also summarizes the discussions of relevant issues by committees of the Legislative Council ("LegCo").

**Basel III**

2. The international standards in the field of banking supervision are set by the Basel Committee on Banking Supervision ("the Basel Committee"). Hong Kong joined the Basel Committee as a member in June 2009. The Basel Committee has previously proposed regulatory frameworks commonly known as Basel I<sup>1</sup>, Basel II<sup>2</sup> and Basel 2.5<sup>3</sup>. 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 ("BO") (Cap. 155), 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"). The two sets of rules are subsidiary legislation subject to the negative vetting procedures of LegCo.

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<sup>1</sup> 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.

<sup>2</sup> Basel II refers to the supervisory approach stipulated in the New Basel Capital Accord published in 2004 to replace Basel I.

<sup>3</sup> Basel 2.5 refers to a set of enhancements to the Basel II framework issued by the Basel Committee in 2009.

3. 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 recent global financial crisis. 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. It increases the level, quality and transparency of banks' capital base, as well as the risk coverage of the capital framework. It sets three minimum risk-weighted capital ratios, two new capital buffers to reduce the procyclicality of the capital framework, a non risk-weighted leverage ratio, and two minimum standards for banks' liquidity. It also strengthens the capital requirements for certain counterparty credit risk exposures of banks.

4. 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 with the implementation beginning in January 2013 and phasing in the standards over the subsequent six years to achieve full implementation by 1 January 2019.

### **Banking (Amendment) Ordinance 2012 and the relevant subsidiary legislation**

5. The Banking (Amendment) Bill 2011 was passed by the LegCo on 29 February 2012 and gazetted as the Banking (Amendment) Ordinance 2012 (3 of 2012) ("BAO") on 9 March 2012. It provides for the legal framework for implementation of Basel III in Hong Kong<sup>4</sup>. The relevant sections of BAO which amend the powers of MA to make rules to prescribe the capital and disclosure requirements for authorized institutions ("AIs")<sup>5</sup>, and the Banking (Capital) (Amendment) Rules 2012, came into operation on 1 January 2013 to implement the first phase of the new Basel III capital framework in Hong Kong<sup>6</sup>. In essence, the Banking (Capital) (Amendment) Rules 2012 have revised the minimum capital ratio requirements applicable to AIs, tightened the criteria for instruments to be recognized as regulatory capital, and extended the

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<sup>4</sup> The Administration introduced the Banking (Amendment) Bill 2011 into LegCo on 21 December 2011. No Bills Committee was formed for scrutiny of the Bill.

<sup>5</sup> Authorized institutions refer to licensed banks, restricted licence banks, and deposit-taking companies authorized under the BO.

<sup>6</sup> 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 was formed to scrutinize the three pieces of subsidiary legislation. The Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012 appointed 1 January 2013 as the day on which the amended powers of MA to make rules to prescribe capital and disclosure requirements for AIs for implementation of Basel III would come into operation. The Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 is to reflect the Basel Committee's decision in May 2010 to include the Multilateral Investment Guarantee Agency in the list of "multilateral development banks" for the purpose of the Basel capital framework.

risk coverage of the capital framework in relation to counterparty credit risk ("CCR") to capture potential loss due to changes in the credit quality of a counterparty (referred to as credit valuation adjustment ("CVA") risk); and exposures to central counterparties ("CCPs").

6. The Administration tabled the Banking (Capital) (Amendment) Rules 2013 and the Banking (Disclosure) (Amendment) Rules 2013 at LegCo on 17 April 2013<sup>7</sup>. The former further amended the Banking (Capital) Rules to clarify principally certain capital treatments for CCR and exposures to CCPs while the latter amended the Banking (Disclosure) Rules to prescribe revised requirements regarding disclosure by AIs of their capital adequacy and associated relevant financial information for the first phase implementation of Basel III capital standards. Both pieces of subsidiary legislation came into operation on 30 June 2013.

### **Discussions by the Panel on Financial Affairs**

7. Issues related to the implementation of Basel III capital standards in Hong Kong were discussed at meetings of the Panel on Financial Affairs held on 21 May and 4 June 2012. Members expressed concerns that implementation of Basel III requirements might result in over-regulation of the banking sector and additional costs on AIs, and small and medium-sized AIs might encounter difficulties in complying with Basel III standards.

8. The Hong Kong Monetary Authority ("HKMA") advised that it would consult the industry on the implementation of Basel III requirements and the Basel Committee would conduct comprehensive evaluations of the implementation of Basel requirements by its members to ensure a level playing field among them. On the cost impact on AIs, HKMA explained that since the capital adequacy ratio for banks in Hong Kong had been maintained at a very high level (standing at 15.8% at the end of 2011 which well exceeded the statutory requirement of 8%), banks in Hong Kong should have no difficulty in complying with the new requirements. On the other hand, strong capital adequacy might help reduce banks' cost for raising additional capital. HKMA added that as revealed by the findings of the bi-annual Quantitative Impact Studies conducted by HKMA on banks, the small and medium-sized banks in Hong Kong had no difficulty in complying with Basel III requirements.

9. As regards the progress of implementing Basel III standards in Hong Kong vis-à-vis that of overseas jurisdictions, the Administration advised that Hong Kong would follow the timeframe set by the Basel Committee in

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<sup>7</sup> The Subcommittee on Banking (Capital) (Amendment) Rules 2013 and Banking (Disclosure) (Amendment) Rules 2013 was formed to scrutinize the two pieces of subsidiary legislation.

implementing Basel III requirements, and aimed to enforce the capital standards starting from 1 January 2013. The Administration added that it was a statutory requirement for HKMA to consult the relevant banking and deposit-taking company associations in introducing the subsidiary legislation for implementation of Basel III standards.

### **Discussion by the Subcommittees for scrutiny of subsidiary legislation relating to Basel III**

10. During the scrutiny of the Banking (Capital) (Amendment) Rules 2012, some Subcommittee members expressed concerns about the impacts of implementation of Basel III capital standards on the borrowing costs of the banking sector and the general business, and whether AIs would become more prudent in lending which might cause difficulty for the small and medium enterprises and members of the public in obtaining credits. HKMA responded that given that AIs' capital adequacy ratio had been maintained at a very high level in general, it was not envisaged that implementation of the new minimum capital adequacy ratios would increase the cost of borrowing for AIs. Nor there would be large-scale capital-raising activities for AIs to meet the new requirements. HKMA also pointed out that as AIs in Hong Kong had been well-capitalized, implementation of the new minimum capital adequacy ratios should not adversely affect AIs' lending to small and medium enterprises, 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 would further enhance the resilience of AI and enable them to continue lending during periods of economic downturn.

11. Noting that some major jurisdictions like the European Union ("EU") and the United States ("US") might experience some delay in the Basel III implementation timetable, some Subcommittee members were concerned that possible delay in other jurisdictions in implementing Basel III on 1 January 2013 might cause competitive disadvantage to AIs in Hong Kong, and enquired whether HKMA would consider introducing flexibility in the implementation timetable in Hong Kong. HKMA advised that recognizing the importance of Basel III in strengthening the financial system, a number of jurisdictions were working towards implementation of the Basel III enhanced capital standards. According to a report of the Basel Committee in October 2012, most of Hong Kong's peers in Asia, including Australia, Mainland China, India, Japan and Singapore, had already issued final rules for Basel III implementation. The EU and the US were also working towards the implementation of Basel III. 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, and the

need for Hong Kong as a major international financial centre to align with the international implementation timetable, the Administration considered that Hong Kong should remain committed to implementing Basel III on 1 January 2013.

12. In scrutinizing the Banking (Capital) (Amendment) Rules 2013 and the Banking (Disclosure) (Amendment) Rules 2013, the Subcommittee noted that some AIs, in particular the small and medium-sized ones, had previously expressed concern about possible impacts of the implementation of the new Basel III requirements on their operation and enquired about the implementation experience of the first phase of Basel III requirements in Hong Kong since January 2013, and whether AIs would encounter challenges in meeting the requirements prescribed in the two sets of amendment rules.

13. HKMA advised that implementation of the first phase of Basel III requirements in Hong Kong had been smooth. According to the results of a recent test run conducted by HKMA for all locally-incorporated AIs to report their capital positions substantially based on the capital standards under Basel III, all participant AIs were able to meet the Basel III capital requirements without difficulty. It was also revealed in the test run that all AIs in Hong Kong had maintained their minimum capital ratio requirements which far exceeded those required under the first phase of Basel III capital framework.

14. Regarding the impact of the amendment rules on the banking sector, the Administration pointed out that the Banking (Disclosure) (Amendment) Rules 2013 prescribed the disclosure requirements by AIs in respect of their capital base under the Basel III capital framework which already took effect on 1 January 2013 and thus would not result in additional capital costs on AIs. Moreover, given that the industry had been engaged in the formulation of the new disclosure requirements for some time, it was not anticipated that the proposed amendments would create any undue compliance burden for AIs. The Administration also advised that the Banking (Capital) (Amendment) Rules 2013 prescribed mostly miscellaneous technical refinements to the CCR framework and the calculation of market risk, which were not expected to have a significant impact on AIs' capital positions. Moreover, the Banking (Capital) (Amendment) Rules 2013 mainly related to capital treatments for CCR and exposures to CCPs which would affect the transactions of over-the-counter derivatives the majority of which were conducted by large AIs. It was unlikely that the operations of the small and medium-sized AIs would be affected.

## **Latest Development**

15. The Administration will consult the Panel at the meeting to be held on 7 July 2014, the proposed amendment to the Banking (Capital) Rules and Banking (Disclosure) Rules, and making of a set of Banking (Liquidity) Rules for implementation of the second phase Basel III standards in Hong Kong.

## **Relevant papers**

16. A list of relevant papers is in the **Appendix**.

Council Business Division 1  
Legislative Council Secretariat  
4 July 2014

## List of relevant papers

| Date                         | Event  | Papers/Minutes of meeting  |
|------------------------------|--|--|
| 29 February 2012             | The Legislative Council ("LegCo") passed the Banking (Amendment) Bill 2011   | <a href="#">Hansard</a><br><br><a href="#">Bill passed</a>   |
| 21 May 2012                  | Briefing by the Hong Kong Monetary Authority to the Panel on Financial Affairs on its work   | <a href="#">Power-point presentation materials by HKMA</a><br>(LC Paper No. CB(1)2080/11-12(01))<br><br><a href="#">Minutes of meeting</a><br>(LC Paper No. CB(1)2267/11-12)   |
| 4 June 2012                  | The Panel on Financial Affairs was briefed on the progress of the implementation of Basel III standards in Hong Kong   | <a href="#">Discussion paper</a><br>(LC Paper No. CB(1)2035/11-12(04))<br><br><a href="#">Background brief</a> prepared by the Legislative Council Secretariat<br>(LC Paper No. CB(1)2034/11-12)<br><br><a href="#">Minutes of meeting</a><br>(LC Paper No. CB(1)2574/11-12) |
| October 2012 – November 2012 | LegCo formed a Subcommittee to scrutinize the Banking (Capital) (Amendment) Rules 2012, Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 and Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012 | <a href="#">Legislative Council Brief</a><br>(File Ref: G4/16/44C)<br><br><a href="#">Legal Service Division Report</a><br>(LC Paper No. LS5/12-13)<br><br><a href="#">Report of the Subcommittee</a><br>(LC Paper No. CB(1)230/12-13)                                       |
| April 2013 – May 2013        | LegCo formed a Subcommittee to scrutinize the Banking (Capital) (Amendment) Rules 2013 and the Banking (Disclosure) (Amendment) Rules 2013 which were tabled in the Legislative Council  | <a href="#">Legislative Council Brief</a><br>(File Ref: G4/16/44C)<br><br><a href="#">Legal Service Division Report</a><br>(LC Paper No. LS39/12-13)<br><br><a href="#">Report of the Subcommittee</a><br>(LC Paper No. CB(1)1047/12-13)                                     |