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Report of the Subcommittee on Banking (Disclosure) (Amendment) Rules 2016 and Banking (Specification of Class of Exempted Charges) (Amendment) Notice 2016

Purpose

This paper reports on the deliberations of the Subcommittee on Banking (Disclosure) (Amendment) Rules 2016 ("BDAR 2016") and Banking (Specification of Class of Exempted Charges) (Amendment) Notice 2016 ("the Amendment Notice").

Background

Basel Committee on Banking Supervision and the Basel framework

2. The Basel Committee on Banking Supervision ("BCBS") is the international body that sets standards on banking regulation with a view to enhancing financial stability. The existing Basel framework comprises three mutually reinforcing "pillars" designed to address the risks faced by banks. Pillars 1 and 2 prescribe the calculation of a series of minimum capital adequacy ratios and a corresponding supervisory review process respectively, whereas Pillar 3 requires public disclosure of key information on banks' capital, liquidity, and risk exposures to facilitate risk assessment in relation to banks and enhance market discipline.¹

¹ BCBS has previously issued regulatory frameworks commonly known as Basel I, Basel II and Basel 2.5. Basel III is the latest 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. BDAR 2016 is part of the legislative initiatives for implementation of on-going enhancements of the regulatory framework in Hong Kong leading on from the Basel III reforms.

3. As a major international financial centre and a member of BCBS, Hong Kong applies the relevant requirements of the Basel framework to locally incorporated authorized institutions ("AIs").² In line with the established practice for codifying Basel standards on regulatory disclosure, standard templates are specified by the Monetary Authority ("MA") for use by AIs under section 6(1)(ab) of the Banking (Disclosure) Rules (Cap. 155M) ("BDR").

International developments in financial regulation

Revised Pillar 3 disclosure requirements

4. In January 2015, BCBS published the latest Pillar 3 disclosure requirements, which aim to improve the comparability and consistency of disclosure between banks and across jurisdictions ("the revised disclosure requirements"). The 2015 Basel Package focuses on the disclosure of information relating to the risk-weighted assets of AIs.³ It prescribes a set of standard templates for banks to make disclosure at specified frequencies (i.e. quarterly, semi-annually or annually) in respect of a series of risks. The existing disclosure requirements put in place under the previous Basel framework will be substantially replaced as a result.

Margin and risk mitigation standards for non-centrally cleared over-the-counter derivatives

5. Following calls to improve transparency and reduce counterparty risk in the over-the-counter ("OTC") derivatives markets in the aftermath of the global financial crisis, BCBS and the International Organisation of Securities Commissions ("IOSCO") jointly promulgated in 2013 a set of standards on margin requirements for OTC derivatives that are not cleared through central counterparties. IOSCO further issued a set of risk mitigation standards for non-centrally cleared OTC derivatives in 2015.

Banking (Disclosure)(Amendment) Rules 2016 and Banking (Specification of Class of Exempted Charges) (Amendment) Notice 2016

6. The Amendment Notice and BDAR 2016 were published in the Gazette on 30 December 2016. The Amendment Notice seeks to include a new class of charge to be exempted from the limitation under section 119A(2) of the Banking

² AIs refer to licensed banks, restricted licence banks, and deposit-taking companies authorized under the Banking Ordinance (Cap. 155).

³ Risk-weighted assets are a key component for calculating the minimum capital requirement of a bank under the BCBS capital framework.

Ordinance (Cap. 155) ("BO"), up to a value equivalent to 5% of an AI's total assets, so as to facilitate implementation of the margin and risk mitigation standards for non-centrally cleared OTC derivatives. BDAR 2016 seeks to:

- (a) apply the revised disclosure requirements to locally incorporated AIs;
- (b) address the lack of quarterly disclosure in Hong Kong of certain key regulatory capital and leverage ratios, as identified by BCBS;⁴
- (c) remove duplication and inconsistencies with similar requirements that already exist in applicable financial reporting standards with which locally incorporated AIs are required to comply under the Companies Ordinance (Cap. 622) ("CO");⁵ and
- (d) enhance the existing disclosure requirements relating to the identification of potential global systematically important AIs.

7. The Amendment Notice and BDAR 2016 will come into operation on 3 March and 31 March 2017 respectively.

The Subcommittee

8. At the House Committee meeting on 6 January 2017, Members agreed to form a subcommittee to study BDAR 2016 and the Amendment Notice. The membership list of the Subcommittee is in the **Appendix**. Under the chairmanship of Hon CHAN Chun-ying, the Subcommittee held one meeting on 19 January 2017 with the Administration to scrutinize the two items of subsidiary legislation.

⁴ BCBS has been conducting a Regulatory Consistency Assessment Programme since 2012 to evaluate the compliance of its member jurisdictions' regulatory frameworks with the minimum Basel III standards and other prevailing capital standards published by BCBS. In a report published by BCBS in 2015, it was observed that Hong Kong lacked the quarterly disclosure requirements specified by BCBS for certain key regulatory ratios.

⁵ The existing provisions under BDR require banks to disclose both (a) "regulatory disclosures" promulgated mainly by BCBS; and (b) "financial disclosures" primarily driven by the Hong Kong Financial Reporting Standards ("HKFRS"). According to the Administration, it is no longer desirable for BDR to continue to prescribe disclosure requirements associated with the financial disclosures, because (a) all locally incorporated AIs are required by CO to make financial disclosures in annual financial statements in compliance with HKFRS; and (b) focusing Pillar 3 reports on regulatory disclosures is a consistent practice adopted by banking supervisors internationally.

9. To allow more time for the Subcommittee to prepare a report on its deliberations for submission to the House Committee, the Subcommittee Chairman moved a motion at the Council meeting of 8 February 2017 to extend the scrutiny period of the two pieces of subsidiary legislation to the Council meeting of 1 March 2017. The motion was passed.

Deliberations of the Subcommittee

10. In the course of its deliberations, the Subcommittee discussed various related issues including the benefits and enforcement of the revised disclosure requirements, investor protection, compliance burden on the banking industry, and the consultation on the two pieces of subsidiary legislation in question. The deliberations are summarized in the ensuing paragraphs.

Banking (Disclosure)(Amendment) Rules 2016

Benefits of adopting the revised disclosure requirements

11. The Subcommittee notes that the revised disclosure requirements are part of BCBS' broader agenda to reform the regulatory standards for banks in response to the global financial crisis which began in 2008. The revisions are designed to improve the transparency of the regulatory disclosures of banks, notably by the greater use of standardized templates for quantitative disclosure accompanied with definitions and qualitative narration. According to the Administration, the application of the revised disclosure requirements to AIs will enable market participants (e.g. rating agencies, financial analysts and investors) to better compare AIs' disclosures of risk-weighted assets, and hence will strengthen market discipline and ultimately risk management of the banking sector. It will also help bolster the resilience of individual AIs to periods of financial stress by allowing market participants to place greater confidence in their understanding of an AI's financial position, thereby reducing the prospects of uninformed panic reactions such as abrupt withdrawal of funding. By reducing the propensity for uninformed speculation and concern, the disclosure can help reduce systemic risk.

12. The Subcommittee has enquired about the exemptions, if any, provided under BDAR 2016 from the revised disclosure requirements. The Administration has advised that under the new section 3(14A) of BDR, MA may, by notice in writing given to an AI, exempt the institution from the application of BDR if MA is satisfied that the institution has not commenced business. As such AIs will not have any information to disclose that will be useful for risk management of the banking sector, the said exemption will not undermine protection of the interests of investors and depositors.

Compliance burden on authorized institutions

13. Under the revised disclosure requirements introduced by BDAR 2016, AIs will be required to make disclosure at specified frequencies (i.e. quarterly, semi-annually or annually) in respect of a series of risks (e.g. credit risk and market risk). Some members are concerned about the readiness of AIs for the revised disclosure requirements which will come into operation from 31 March 2017, and the compliance burden on AIs in the long run.

14. The Administration has advised that HKMA engaged the banking industry in formulating the proposals contained in BDAR 2016 through a consultation initiated in December 2015. Given the long lead time between consultation and commencement of the revised disclosure requirements, the industry should have sufficient time to get prepared. Besides, since the information to be disclosed is largely existing information already kept by individual AIs, and standard templates will be used for making quantitative disclosures, it is envisaged that the revised disclosure requirements will not give rise to undue compliance costs on AIs. In fact, from the perspective of enhancing transparency and minimizing uninformed speculation in respect of an AI's financial position or risk profile, the revised disclosure requirements could reduce the AI's funding costs, and hence it should be in the interests of AIs to comply with the revised disclosure requirements.

15. The Subcommittee further notes that BDAR 2016 revise the existing provisions of BDR in relation to the financial disclosure requirements for locally incorporated AIs to remove duplication and inconsistencies with similar requirements that already exist in applicable financial reporting standards with which such AIs are required to comply under CO. According to the Administration, this will facilitate disclosure by the industry as AIs will only need to refer to a single set of standards (i.e. the applicable financial reporting standards) for making financial disclosures.

Enforcement of the revised disclosure requirements

16. As the standard disclosure templates of the 2015 Basel Package are not attached to BDAR 2016 and form part of BDR, the Subcommittee has enquired whether AIs can exercise flexibility in adopting the templates or not, and how the accuracy of the information disclosed by AIs will be ensured.

17. The Administration has advised that the revised section 6(1)(ab) of BDR mandates AIs to use the standard disclosure templates specified by MA. BDAR 2016 adds a new Part 2A to BDR to outline the key requirements and disclosure frequency for each standard disclosure template, together with the requirement that, where appropriate, quantitative disclosures should be accompanied with a qualitative explanation of any material changes observed

during the relevant reporting period. Moreover, the revised sections 3, 6 and 8 of BDR reflect the requirements in the 2015 Basel Package regarding disclosure frequencies, the medium and location of disclosure, as well as the quality assurance of information disclosed.

18. As regards quality assurance of information to be disclosed by an AI, the Administration points out that the revised section 8 of BDR enhances the verification by requiring, not just the AI's senior management as under the existing arrangement, but also its board of directors, to ensure that the information required to be disclosed is, before being so disclosed, scrutinized and subjected to an internal review such that the information is not false or misleading in any material aspect. BDAR 2016 also introduce a new requirement that the AI must ensure that one or more members of the senior management of the institution attest in writing that the disclosures made by the institution pursuant to BDR have been prepared in accordance with the internal review and internal control processes approved by the institution's board of directors. Concerning semi-annual and annual disclosures, these processes must be no less stringent than those applied to the information provided by the institution within the management discussion and analysis part of its financial statements. Meanwhile, BDR will retain the existing requirement that the internal review shall be carried out by adequately qualified personnel of the AI who are independent of the AI's staff or management responsible for preparing the information.

19. On enforcement of the revised disclosure requirements, the Administration has advised that MA is empowered by section 60A of BO to make rules prescribing the information to be disclosed to the general public by AIs, including giving effect to banking supervisory standards relating to disclosure issued by the Basel Committee. Where an AI fails to comply with any requirement applicable to it contained in the rules including BDR, the directors, chief executive and managers of the AI commit an offence, and are liable to penalty fines. The powers to enforce BDR including the revised disclosure requirements are derived from and prescribed by the relevant provisions of BO.

Powers of the Monetary Authority to direct an authorized institution to make disclosure regarding its systemic importance

20. The Subcommittee notes that BDAR 2016 have expanded the circumstances under which MA may direct an AI to make the disclosures applicable to global systemically important banks ("GSIBs") under section 45C(3) of BDR. In addition to the criteria currently specified in section 45C(1) and (2), MA may under the new section 45C(2A)(b) subject an AI to the GSIB disclosure requirements if he has reason to believe that the institution would be capable of having a significant impact on the effective

working and stability of the global financial system were the institution to become non-viable.

21. The Subcommittee has enquired about the guidelines, if any, for MA to determine whether an AI "would be capable of having a significant impact on the effective working and stability of the global financial system were the institution to become non-viable". The Administration has advised that in exercising his functions under BO, MA is required to act reasonably and in the interests of depositors or potential depositors. In determining whether an AI would be capable of having a significant impact on the effective working and stability of the global financial system, MA will carefully consider the institution's characteristics, including its risk profile and business, among other factors.

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Investor protection

22. Referring to the Lehman Brothers incident in 2008, which revealed the structural deficiencies in the OTC derivatives market, members stress the importance to exercise effective regulation over the sale of complex financial products including OTC derivatives. In this connection, the Subcommittee has enquired about the impact, if any, of the exemption introduced by the Amendment Notice on investor protection.

23. The Administration has explained that section 119A of BO governs the creation by a locally incorporated AI of charges over its assets. Under section 119A(2), except with the approval of MA, an AI is prohibited from creating charges under certain circumstances (e.g. if the aggregate value of all charges existing over its total assets is 5% or more of the value of those total assets). The limitation, however, does not apply to the classes of charges specified in the Banking (Specification of Class of Exempted Charges) Notice (Cap. 155K). During consultation on the proposals for the local implementation of the margin and risk mitigation standards, HKMA noted the industry's concern that the exchange of initial margin between an AI and its counterparty in an OTC derivatives transaction as required would create a "charge" as defined under section 119A(1) of BO, and thus have implications for AIs' compliance with the limitation under section 119A(2). To facilitate the industry's compliance with the latest margin and risk mitigation standards, it is therefore necessary to exempt, by way of amending Cap. 155K, charges relating to the provision of initial margin for OTC derivatives transactions from the aforesaid prohibition, up to a value equivalent to 5% of an AI's total assets. The Administration has emphasized that the above approach aims to strike a balance between facilitating the implementation of the margin and risk mitigation standards and preserving the integrity of section 119A of BO.

24. The Administration has further advised that the initial margin in question protects the non-defaulting party to an OTC derivatives transaction by allowing it to use the collateral received from the defaulting entity to absorb losses on close-out of the transaction, and helps market participants to better internalize the cost of their risk-taking, because they will have to post collateral when they enter into derivatives contracts. For these reasons, the exemption sought by the Amendment Notice, which facilitates AIs' compliance with the international margin and risk mitigation standards for non-centrally cleared OTC derivatives thereby improving AIs' risk management, is in line with the interests of investors and depositors.

25. The Subcommittee notes that under the margin and risk mitigation standards to be implemented for non-centrally cleared OTC derivatives, the initial margin posted/collected by an AI must be segregated and may be held by one or more unaffiliated custodians in such a way to ensure that the margin posted/collected is available to the non-defaulting party in the event of the counterparty's default in an OTC derivatives transaction. The Administration has advised that while AIs are given the flexibility to choose the custodian(s), it is common for AIs to use international clearing houses such as Euroclear as custodians to hold the initial margin in respect of non-centrally cleared OTC derivatives.

26. In response to members' concerns about the monitoring of build-up of exposures to OTC derivatives transactions conducted by AIs, the Administration has advised that a regulatory framework for the OTC derivatives market in Hong Kong is in place to require, among others, mandatory reporting of OTC derivatives transactions to the trade repository operated by HKMA. Taking into account the volume of transactions, certain types of interest rate swaps and non-deliverable forwards are specified as the major types of OTC derivatives transactions conducted in Hong Kong that are subject to the mandatory reporting requirements at present. For OTC derivatives transactions conducted by AIs outside Hong Kong, the reporting will be made to the trade repository designated by the relevant authority of the overseas jurisdiction concerned.

Consultation on the two pieces of subsidiary legislation

27. Some members have queried why the Administration had only engaged the banking industry but not conducted public consultation on BDAR 2016 and the Amendment Notice. The Administration has advised that given the complexity and highly technical nature of the legislative amendments, it is appropriate to consult the banking industry only. In accordance with section 60A of BO, MA has issued a draft of the relevant provisions of BDAR 2016 to consult the Financial Secretary, the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, the Hong Kong Association of Banks, and the Hong Kong Association of Restricted Licence

Banks and Deposit-taking Companies in October 2016. Responses received were generally supportive of the amendments. Relevant technical or drafting comments have been addressed in the finalized rules as appropriate, and the intents of certain provisions have been clarified. In respect of the Amendment Notice, MA consulted the banking industry in November 2016 and received responses indicating general support for the amendment. The Administration emphasizes that it is incumbent upon Hong Kong, as a major international financial centre and a member of BCBS and IOSCO, to adopt the revised disclosure requirements as well as the margin and risk mitigation standards for non-centrally cleared OTC derivatives, so as to ensure that the relevant local regulatory requirements are consistent with the international standards.

Drafting issues

28. In relation to the Amendment Notice, the Legal Adviser to the Subcommittee has enquired about the reasons for certain differences, compared to the existing provisions, in the drafting of the revised section 2(1) of Cap. 155K concerning description of the classes of charges to be exempted.⁶ The Subcommittee has noted the Administration's explanation that the drafting approach is intended to simplify the texts as far as practicable while not undermining the clarity of the provisions in question. The Subcommittee has raised no objection in this respect.

Recommendation

29. Subcommittee members have no objection to BDAR 2016 and the Amendment Notice. The Subcommittee and the Administration will not move any amendment to the two pieces of subsidiary legislation.

Advice sought

⁶ Under the existing section 2(1) of Cap. 155K, the classes of charges to which section 119A(2) of BO does not apply include charges created in favour of Euroclear Bank S.A. (acting as operator of the Euroclear System) by an AI incorporated in Hong Kong, and charges created in favour of Clearstream Banking S.A. by an AI incorporated in Hong Kong. In the revised version under the Amendment Notice, the phrase "by an authorized institution incorporated in Hong Kong" is omitted in the description of each of the aforesaid classes of charges.

30. Members are invited to note the deliberations of the Subcommittee.

Council Business Division 1
Legislative Council Secretariat
9 February 2017

Appendix

Subcommittee on Banking (Disclosure) (Amendment) Rules 2016 and Banking (Specification of Class of Exempted Charges) (Amendment) Notice 2016

Membership list

Chairman Hon CHAN Chun-ying

Members Hon WONG Ting-kwong, SBS, JP
 Hon YIU Si-wing, BBS
 Dr Hon KWOK Ka-ki
 Hon Christopher CHEUNG Wah-fung, SBS, JP
 Dr Hon YIU Chung-yim

(Total : 6 members)

Clerk Ms Angel SHEK

Legal Adviser Mr YICK Wing-kin

Date 19 January 2017