

立法會
Legislative Council

LC Paper No. CB(1)291/17-18

Ref : CB1/SS/5/17

Paper for the House Committee meeting on 1 December 2017

**Report of the Subcommittee on Banking (Capital) (Amendment)
Rules 2017, Banking (Liquidity) (Amendment) Rules 2017 and
Banking (Specification of Multilateral Development Bank)
(Amendment) Notice 2017**

Purpose

This paper reports on the deliberations of the Subcommittee on Banking (Capital) (Amendment) Rules 2017, Banking (Liquidity) (Amendment) Rules 2017 and Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2017 ("the Subcommittee").

Background

2. The international standards on banking regulation are set by the Basel Committee on Banking Supervision ("the Basel Committee"). It has previously proposed regulatory frameworks commonly known as Basel I¹, Basel II² and Basel 2.5³ in respect of regulatory standards for banks' capital and liquidity requirements. Hong Kong joined the Basel Committee as a member in June 2009.

3. Building on Basel 2.5, the Basel Committee promulgated the Basel III framework, which 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 of recent years. The Basel III framework seeks to improve the banking sector's ability to absorb

¹ 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.

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

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

shocks arising from financial and economic stress, and to reduce the risks of any spillover from the banking sector to the real economy. The framework aims to increase the level, quality and transparency of banks' capital base, as well as the risk coverage of the capital framework.

4. The Basel III framework was endorsed by the G20 Leaders in November 2010, who are committed to implementing the new standards using a phased-in approach beginning in January 2013 and achieving full implementation by 1 January 2019.

5. Following the Basel III transitional arrangements, Hong Kong has been implementing the relevant capital, disclosure and liquidity standards in earlier phases starting from 1 January 2013, through amending the Banking (Capital) Rules (Cap. 155 sub. leg. L) ("BCR") and the Banking (Disclosure) Rules (Cap. 155 sub. leg. M), and making the Banking (Liquidity) Rules (Cap. 155 sub. leg. Q) ("BLR"), from 2012 to 2014.

The three pieces of subsidiary legislation

Banking (Capital) (Amendment) Rules 2017

6. The Banking (Capital) (Amendment) Rules 2017 ("BCAR 2017") are made by the Monetary Authority ("MA") under section 97C of the Banking Ordinance (Cap. 155) ("BO") after consultation with the Financial Secretary and certain specified persons⁴ ("Statutory Consultees") to amend BCR. Its main purpose is to implement the Basel III capital standards relating to the securitization exposures⁵, leverage ratio⁶ and expected loss provisions⁷ of an

⁴ The persons are 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.

⁵ "Securitization exposure" is defined to mean under the new section 2(1) of the Banking (Capital) Rules ("BCR") an exposure of a person to a securitization transaction, including such an exposure arising from: (a) the purchase or repurchase of securitization issues; (b) the provision of credit protection or credit enhancement to any of the parties to the transaction; (c) the retention of one or more than one exposure to a tranche in the transaction; (d) the provision of a liquidity facility or servicer cash advance facility for the transaction; or (e) the obligation to acquire any investors' interest in the underlying exposures of the transaction if the transaction is subject to an early amortization provision.

⁶ The newly introduced leverage ratio is designed to supplement the risk-based capital adequacy ratios in preventing the excessive build-up of leverage by banks.

⁷ The new standard requires firms to provide for the impairment of financial assets based on an "expected loss" approach instead of the existing "incurred loss" approach.

authorized institution⁸ ("AI"). BCAR 2017 also introduces miscellaneous amendments to BCR, such as to designate the Hong Kong Science and Technology Parks Corporation as a domestic public sector entity⁹, to update the quantitative threshold of annual turnover for defining "small business" from HK\$50 million to HK\$100 million¹⁰, and to refine some existing provisions to enhance the clarity of terminology in certain areas.

Banking (Liquidity) (Amendment) Rules 2017

7. The Banking (Liquidity) (Amendment) Rules 2017 ("BLAR 2017") are made by MA under section 97H of BO after consultation with the Statutory Consultees to amend BLR to introduce a new two-tier regime requiring certain AIs to finance their activities with sufficiently stable sources of funding.

8. After the commencement of BLAR 2017, category 1 institutions¹¹ designated by MA must maintain a net stable funding ratio ("NSFR")¹² of not less than 100%, subject to self-rectification of shortfall. Category 2A institutions¹³ to be designated by MA must maintain an average core funding ratio ("CFR") of at least 50% in each calendar month during 2018, and not less than 75% in each calendar month from 1 January 2019. The new Part 9 of and

⁸ Under section 2(1) of the Banking Ordinance (Cap. 155) ("BO"), "authorized institution" ("AI") means a bank, a restricted licence bank or a deposit-taking company.

⁹ An entity designated as a domestic public sector entity is eligible for preferential risk-weighting treatment under the Banking (Capital) Rules ("BCR"). The designation is based on the criteria that the entity is (a) majority-owned and established by the Government, (b) set up for public policy objectives, and (c) of high credit-worthiness.

¹⁰ Under BCR, exposures to "small business" (subject to some conditions being met) are eligible for certain preferential risk-weighting treatment. In terms of the size of annual turnover, the definition of "small business" under BCR follows that for defining small and medium-sized enterprises covered by the commercial credit database.

¹¹ The Monetary Authority ("MA") has specified as category 1 institutions mainly those AIs with total assets, or external claims and liabilities, of HK\$250 billion or more.

¹² According to paragraph 4 of the Explanatory Note of Banking (Liquidity) (Amendment) Rules 2017, the net stable funding ratio requirements seek to reduce funding risk of category 1 institutions over a longer time horizon.

¹³ MA may designate a non-category 1 institution as a category 2A institution after taking into account the size of its business operation and the liquidity risks associated with it (new rule 3A(2) of the Banking (Liquidity) Rules). According to the Administration, category 2A institutions will include AIs with total assets of HK\$20 billion or more (locally incorporated AIs) or HK\$100 billion or more (foreign bank branches). 34 AIs are expected to meet these criteria and be subject to the core funding ratio regime.

Schedule 6 to BLR provide for the calculation of NSFR, CFR and related factors.

Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2017

9. Under section 2(19) of BO, MA may by notice published in the Gazette specify to be a multilateral development bank ("MDB") 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 MDBs are treated more favourably for the purposes of calculating an AI's capital adequacy ratio and liquidity ratio.

10. The Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2017 ("Specification Notice 2017") amends the existing Notice to specify the International Development Association ("IDA") as a new MDB under BO. The amendment is made to implement the Basel Committee's decision made in November 2016 to include IDA, a member of the World Bank Group, as an MDB for preferential treatment under the capital regime. Specification Notice 2017 also amends the Chinese text of the existing Notice to incorporate the Chinese names of seven existing MDBs¹⁴.

11. The three pieces of subsidiary legislation are to come into operation on 1 January 2018.

The Subcommittee

12. At the House Committee meeting on 27 October 2017, members agreed to form a subcommittee to study the three pieces of subsidiary legislation. Hon CHAN Chun-ying was elected Chairman of the Subcommittee. The membership list of the Subcommittee is in **Appendix**. The Subcommittee has held one meeting with the Administration to examine the three pieces of subsidiary legislation.

13. To allow more time for the Subcommittee to report its deliberations to the House Committee, the Chairman has given notice to move a resolution at the

¹⁴ The seven multilateral development bank ("MDBs") are International Bank for Reconstruction and Development, International Finance Corporation, African Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank, European Investment Bank, and Nordic Investment Bank. Upon the Legal Adviser to the Subcommittee's enquiry on the reason for not incorporating the Chinese names of the other five MDBs into the Chinese text of BO, the Administration has advised that local legislation does not contain Chinese renditions of the English names of these MDBs.

Council meeting of 22 November 2017 to extend the scrutiny period for the three pieces of subsidiary legislation to the Council meeting of 13 December 2017. When the Council meeting of 22 November 2017 was adjourned, the agenda on the proposed resolution was not reached. The scrutiny period for the three pieces of subsidiary legislation therefore expired at the Council meeting of 22 November 2017.

Deliberations of the Subcommittee

Impact of the implementation of Basel III standards on the banking industry

14. The Subcommittee has enquired about the consultation with the banking industry on the implementation of the Basel III standards in BCAR 2017 and BALR 2017, possible difficulties for banks to comply with the new standards and the timetable for implementing the new standards in Hong Kong vis-à-vis other member jurisdictions of the Basel Committee. Subcommittee members have also raised questions about possible consequences if Hong Kong does not implement the new standards in accordance with the Basel Committee's timetable. There is the concern that the competitiveness of banks in Hong Kong may be undermined if the implementation schedule is ahead of other jurisdictions.

15. The Government has responded that it does not envisage major difficulties for AIs to comply with the new requirements introduced by BCAR 2017 and BLAR 2017. Hong Kong has been implementing the Basel III framework in phases starting from 1 January 2013 and the banking industry is aware of the relevant timetable and has made preparation as appropriate. The Hong Kong Monetary Authority ("HKMA") has required AIs to report their leverage ratio regularly since 2013. The securitization exposures of AIs in general account for only 0.2% of the overall exposures. The revised securitization framework is not expected to have significant impact on AIs' capital requirement. Furthermore, the new NSFR requirement will only apply to "category 1 institutions" which are sizable or internationally active AIs specified by MA mainly with total assets or external claims and liabilities of HK\$250 billion or more.

16. The Government has supplemented that it has closely engaged the banking industry in formulating the legislative proposals introduced by BCAR 2017 and BLAR 2017, and conducted statutory consultation with the Statutory Consultees. There is general support for the proposals. The finalized rules have taken into account relevant technical or drafting comments from the industry as appropriate.

17. The Government has stressed that it is incumbent upon members of the Basel Committee including Hong Kong to implement the Basel III requirements in accordance with the internationally agreed timeline. This will ensure the robust development of Hong Kong's banking system, and add to Hong Kong's credibility as an international financial centre. Given that banks in all member jurisdictions of the Basel Committee are expected to meet the new capital and liquidity requirements, there should not be any adverse impact on the competitiveness of the Hong Kong banking industry. The Government has supplemented that international organizations on financial cooperation such as the International Monetary Fund and the Financial Stability Board conduct regular evaluation on the financial regulatory regimes of various economies around the world, and the compliance with and effective implementation of the Basel Committee's regulatory standards are among the various assessment criteria.

18. As regards the timetable for the implementation of Basel III standards, the Government has advised that Hong Kong has been following the timetable promulgated by the Basel Committee. The implementation date of 1 January 2018 for BCAR 2017 and BLAR 2017 is in line with the Basel Committee's timetable. On the implementation timetable of other jurisdictions, the Government has pointed out that Basel Committee member jurisdictions including the United States, states in the European Union and China have already implemented the new leverage ratio while Singapore and Australia will also implement the new capital and liquidity requirements on 1 January 2018. The Government is not aware of any BCBS members in the Asia-Pacific region indicating that they are not following the Basel Committee's timetable.

Compliance by authorized institutions with the new Basel III capital and liquidity requirements

19. Some Subcommittee members are concerned how HKMA will monitor AIs' compliance with the requirements introduced by BCAR 2017 and BLAR 2017, and have enquired whether HKMA will require the external auditor appointed by an AI to certify the AI's compliance with the requirements.

20. The Government has advised that HKMA employs various supervisory measures over AIs to ensure compliance of the various capital and liquidity requirements under BO, such as requiring AIs to submit regular returns on their capital and liquidity positions which are closely examined by HKMA. Besides, HKMA conducts on-site examination on AIs' operation. HKMA may require an AI to appoint an external auditor for checking whether a return submitted is correctly compiled and whether the AI has in place adequate systems of control to ensure the correct compilation of returns to HKMA. Where necessary, HKMA may arrange tripartite meetings with the external auditor and the AI concerned to discuss and follow up issues of concern.

Revised securitization framework under Banking (Capital) (Amendment) Rules 2017

21. The Subcommittee has enquired how the revised securitization framework can improve the calculation of risk-weighted capital of AIs' securitization exposures.

22. The Government has explained that under the existing securitization framework (as specified in the pre-amended BCR), there are two approaches for calculating capital requirement of AIs' securitization exposures, viz., the Standardized Approach ("SA") and the Internal Ratings-Based Approach ("IRBA"). Under SA, AIs are required to use external credit ratings in the calculation of the risk-weighted capital for their securitization exposures. AIs adopting IRBA are also required to use the external credit ratings for their calculation if such ratings are available (and it is only when external credit ratings are not available that, subject to MA's approval, such AIs may use an approach based on internal assessment). The revised securitization framework under Basel III will replace the existing framework in BCR. The revised framework introduces new calculation methodologies designed to reduce mechanistic reliance by AIs on external credit ratings when they calculate the risk-weighted capital required for securitization exposures. In addition, the revised framework increases the risk sensitivity of the framework by putting more focus on the risk characteristics of the underlying exposures of a securitization transaction and taking into account more risk drivers, such as the seniority and maturity of a securitization tranche, for calculating the risk-weighted capital.

23. Subcommittee members have enquired whether AIs will be allowed to use other approaches to calculate the risk-weighted capital, particularly if the external credit ratings of the securitized products are more prudent and hence can better reflect the risk level of the AI's securitization exposures.

24. The Government has explained that the revised securitization framework under Basel III has prescribed a hierarchy of risk-weighting approaches with the order from top to bottom: IRBA, the External Ratings-Based Approach, and SA. AIs concerned will be required to apply these approaches in the order above. The Government has pointed out that the application of an approach within the hierarchy will depend on the information that is available to the AIs concerned and on the type of analysis and estimation they can perform for a specific transaction. Where none of the approaches within the hierarchy can be applied to a securitization exposure, an AI is required to risk-weight the exposure at 1,250%. The revised securitization framework allows AIs to take into account a host of factors specified by the Basel Committee in the calculation of risk-weight capital instead of solely relying on external credit ratings. There will be stringent requirements for using IRBA.

HKMA requires banks to take prudent risk management measures. AIs are expected to closely monitor, among other things, the external credit ratings of their securitization exposures and respond to changes in such ratings as appropriate.

25. Subcommittee members have enquired whether the improvements in AIs' calculation of risk-weighted capital for their securitization exposures will help enhance protection for investors especially retail investors in investment products. The Government has reiterated that the enhanced capital and liquidity requirements under the Basel III aim at strengthening the resilience of banks in the aftermath of the global financial crisis, thereby contributing to the overall stability of the banking system and thus increasing protection for depositors at large. The Government has further clarified that regulation of investment products is within the purview of the Securities and Futures Commission which will take into account the suitability of the products concerned for the investors.

26. The Subcommittee has noted the enquiry raised by the Legal Adviser to the Subcommittee with the Administration about a typographical error in the phrase "the securitization exposure are backed" in the new section 242(6) of BCR when the term is intended to be expressed in the plural form (i.e. "securitization exposures"). The Government has replied that the error is noted and considered it unlikely to cause any interpretation difficulties. The Government has undertaken to correct the error when the earliest opportunity arises.

Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2017

27. Subcommittee members have asked if an MDB specified by MA will be regarded as an AI under BO, and hence will continue to be entitled for interests deduction in taxation. The Government has explained that while AIs' exposures to MDBs will be accorded preferential capital and liquidity treatments, MDBs are not AIs themselves under BO. An AI is a commercial entity while an MDB is a bank or lending or development body established by agreements between, or guaranteed by, two or more countries, territories or international organizations other than for purely commercial purposes.

Recommendation

28. The Subcommittee generally supports the three pieces of subsidiary legislation and does not intend to propose any amendments to them.

Advice sought

29. Members of the House Committee are requested to note the deliberations of the Subcommittee.

Council Business Division 1
Legislative Council Secretariat
30 November 2017

**Subcommittee on Banking (Capital) (Amendment) Rules 2017,
Banking (Liquidity) (Amendment) Rules 2017 and Banking (Specification
of Multilateral Development Bank) (Amendment) Notice 2017**

Membership list

Chairman Hon CHAN Chun-ying

Members Hon James TO Kun-sun
Hon WONG Ting-kwong, GBS, JP
Hon CHAN Kin-por, GBS, JP
Hon YIU Si-wing, BBS
Hon Kenneth LEUNG
Hon Christopher CHEUNG Wah-fung, SBS, JP
Hon Alvin YEUNG
Hon Jimmy NG Wing-ka, JP

(Total : 9 members)

Clerk Ms Connie SZETO

Legal Adviser Mr Bonny LOO