

## **LEGISLATIVE COUNCIL BRIEF**

### **Banking Ordinance (Chapter 155)**

#### **BANKING ORDINANCE (AMENDMENT OF THIRD SCHEDULE) NOTICE 1999**

### **INTRODUCTION**

The Financial Secretary is going to make the Banking Ordinance (Amendment of Third Schedule) Notice 1999 (the Notice) on 24 December 1999.

### **BACKGROUND AND ARGUMENT**

2. The Third Schedule of the Banking Ordinance provides for the measurement of an authorized institution's (AI's) capital adequacy ratio (CAR). An AI's capital adequacy is the ratio of its capital base to its risk weighted exposures.

#### **Revaluation reserves on non-trading securities**

3. Before April 1999, the Hong Kong Society of Accountants (HKSA) did not have any formal guideline on the treatment of revaluation reserves of securities. In April 1999, HKSA issued the new Statement of Standard Accounting Practice No. 24 on Accounting for Investments in Securities (SSAP 24), which classifies investments in securities into "held-to-maturity securities"<sup>1</sup> and "investments other than held-to-maturity securities".

4. For "investments other than held-to-maturity securities", SSAP 24 prescribes two alternative treatments – benchmark<sup>2</sup> and alternative. Under the

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<sup>1</sup> Under SSAP 24, investments in debt securities should be classified as "held to maturity" and measured at amortized cost in the balance sheet if, and only if, an entity has the expressed intention and ability to hold those securities to maturity.

<sup>2</sup> Under the benchmark treatment, "investments other than held-to-maturity securities" are classified into "investment securities" and "other investments". "Investment securities" are measured at cost and may carry latent reserves – counted as Supplementary Capital in an AI's capital base – when the market value of the securities is greater than the book value. "Other investments" are measured at fair value with the revaluation gains or losses recognized in the profit and loss account.

alternative treatment, “investments other than held-to-maturity securities” are classified into “trading securities” and securities which are not held for trading purposes (non-trading securities). “Non-trading securities” are measured at fair value, but the revaluation gains or losses arising therefrom are recognized in a revaluation reserve account holding such gains or losses until disposal.

5. Under the current framework in the Third Schedule to the Banking Ordinance for calculating the capital adequacy ratio (CAR)<sup>3</sup>, 100% of such revaluation reserve arising from “non-trading securities” are included indistinguishably as part of the Core Capital within item 3(d) - “reserves”. The Hong Kong Monetary Authority (HKMA) considers it inappropriate to count such revaluation reserve as Core Capital. Firstly, it is not consistent with the Basle Committee’s recommendation that revaluation reserves should be counted as Supplementary Capital. Secondly, the arrangement will subject an AI’s reserves as part of its Core Capital to the volatility of the prices of the relevant securities.

6. Therefore, the Third Schedule will be amended to include a new item for the reporting of the revaluation reserves from “non-trading securities” under the alternative treatment as Supplementary Capital. In addition, the revaluation surplus that can be reported will be subject to a discount of 30%.

### **Property revaluation reserves**

7. Paragraph 3(h) of the Third Schedule provides that an AI may include as Supplementary Capital its reserves on revaluation of its properties up to an amount not exceeding 70% of any surplus on revaluation. During 1998, substantial adjustment in property price significantly affected the CARs of those AIs whose property revaluation reserves form part of their capital base.<sup>4</sup>

8. To limit the effect of volatility in property prices on an AI’s CAR, paragraph 3(h) of the Third Schedule will be amended so that the amount of revaluation reserves arising from land and interests in land that can be counted as

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<sup>3</sup> Capital adequacy ratio of an AI is the ratio, expressed as a percentage, of its capital base determined in accordance with paragraph 3 of the Third Schedule, to its risk weighted exposure determined in accordance with paragraph 4 of the Third Schedule.

<sup>4</sup> As property revaluation reserves fall with property price, an AI’s capital base drops. The AI’s risk weighted exposure will also drop accordingly. However, as reduction of HK\$1 in capital base has a more substantial effect on the capital adequacy ratio than reduction of HK\$1 in risk weighted exposure arithmetically, the net result is reduced capital adequacy.

an AI's Supplementary Capital shall not exceed the amount so included as at 31 December 1998. This is in addition to the existing requirement that the amount included shall not exceed 70% of any surplus on revaluation. Accordingly, an AI will also be allowed to deduct from its total risk weighted exposure the amount of reserves on revaluation of its land and interests in land in excess of the book value of such reserves as at 31 December 1998.

### **Miscellaneous changes**

9. The practice of maintaining inner reserves, i.e. undisclosed reserves of an AI, has already been phased out in Hong Kong to improve the transparency of the banking sector. Accordingly, paragraph 3(g) "Inner Reserves" of the Third Schedule will be repealed.

10. Paragraph 1 of the Third Schedule sets out the definition of "public sector entities", an AI's claims on which are counted as the AI's risk weighted exposure when calculating the CAR. The definition will be amended to include the following bodies, which the Monetary Authority has already specified as public sector entities under the Banking Ordinance:

- (a) the Hospital Authority;
- (b) the Airport Authority; and
- (c) The Hong Kong Mortgage Corporation Limited.

11. Paragraphs 3(i)(i) and 3(i)(ii) of the Third Schedule will be amended to specify more clearly that an AI's overall surplus on revaluation of its long-term holding of listed equity securities eligible for inclusion as latent reserves should be limited to 45% of such surplus while the overall deficit should be fully deducted.

12. Item 28 of Table A<sup>5</sup> of the Third Schedule will be amended to specify more clearly that assets which have been deducted from the capital base should not be included in this item when calculating the capital adequacy ratio.

### **THE NOTICE**

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<sup>5</sup> Table A of the Third Schedule sets out the risk weights of on-balance sheet items for the purpose of computing the risk weighted exposure of an AI.

13. Under section 135(3) of the Banking Ordinance, the Financial Secretary may, by notice in the Gazette, amend the Third Schedule.

14. This Notice to be made by the Financial Secretary will amend the Third Schedule to: -

- (a) include revaluation reserves arising from securities not held for trading purposes as Supplementary Capital and at an appropriate discount;
- (b) limit the revaluation reserves arising from land and interests in land that can be included in Supplementary Capital to the amount reported by an AI at 31 December 1998; and
- (c) clarify the wordings of certain other provisions in the Schedule

for the purpose of calculating the capital adequacy of an AI.

#### **PUBLIC CONSULTATION**

15. We have consulted the Hong Kong Association of Banks and the DTC Association and taken account of their opinions.

#### **BASIC LAW IMPLICATIONS**

16. The Department of Justice advises that the Notice is consistent with the Basic Law.

#### **HUMAN RIGHTS IMPLICATIONS**

17. The Department of Justice advises that the Notice has no human rights implications.

#### **BINDING EFFECT OF THE LEGISLATION**

18. The amendments will not affect the current binding effect of the existing provisions of the Banking Ordinance.

## **FINANCIAL AND STAFFING IMPLICATIONS**

19. There are no financial or staffing implications for the Government.

## **LEGISLATIVE TIMETABLE**

20. The Notice, being subsidiary legislation, will come into operation when it is published in the Gazette on 24 December 1999. The Notice will be tabled at the Legislative Council on 29 December 1999 for negative vetting.

## **PUBLICITY**

21. The HKMA will issue to all AIs a letter on the amendments upon gazetting of the Notice.

## **ENQUIRIES**

22. Inquiries on this brief may be directed to Mr Frederic Lau, Head (Banking Policy) of HKMA (telephone number: 2878 1620) or Mr Edward Mak, Assistant Secretary for Financial Services (telephone number: 2527 3974).

**Financial Services Bureau  
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