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Panel on Financial Affairs
Meeting on 4 May 2006

Background Brief
on the development of capital and disclosure rules
to be made under the Banking (Amendment) Ordinance 2005

Purpose

This paper sets out the background to the development of Capital Rules and Disclosure Rules for the implementation of the New Basel Capital Accord in Hong Kong, and summarizes the major concern of the Bills Committee on Banking (Amendment) Bill 2005 on the Rules.

Background

2. The international standards in the field of banking supervision are set by the Basel Committee on Banking Supervision (the Basel Committee)¹. Hong Kong is not a member of the Basel Committee, but together with around 100 other supervisors world-wide has pledged to adopt the standards set by the Committee.

3. A key element of the Basel supervisory approach is the capital adequacy ratio (CAR) set out in the Basel Capital Accord adopted in 1988 (known as “Basel I”). The CAR is important because it provides a buffer against losses, thus providing protection to depositors. Under Basel I, the CAR is calculated by dividing a bank’s capital base by its risk-weighted assets (arrived at by multiplying each asset class by the specified risk weight), and the minimum CAR is 8%.

¹ The Basel Committee on Banking Supervision was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives from banking supervisory authorities and the central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. The Committee usually meets at the Bank for International Settlements (BIS) in Basel, where its permanent Secretariat is located.

4. Basel I and its subsequent amendments have been adopted in Hong Kong through legislation under Part XVII of and the Third Schedule to the Banking Ordinance (BO) (Cap. 155). The detailed requirements for computing CAR requirements are set out in the legislation and supplemented by supervisory guidelines and technical notes issued by the Hong Kong Monetary Authority (HKMA). While authorized institutions (AIs) in Hong Kong are required to maintain a minimum CAR at 8%, most AIs are maintaining an average ratio of 15% to 16%.

5. In order to address the limitation of Basel I and respond more directly to the financial developments in recent years, the Basel Committee issued in June 1999 a proposal for a New Basel Capital Accord (known as “Basel II”) to replace Basel I. Basel II aims to provide an impetus to, and incentive for, banks to enhance risk measurement and management capabilities, and to promote market discipline by means of improved disclosure. It is a major step forward in terms of identification, quantification and management of risk. The Basel Committee finalized and published Basel II in the end of June 2004. In accordance with the Basel Committee’s timetable, it was expected that Basel II would be implemented globally with effect from 1 January 2007².

6. Given that Basel II would promote the adoption of stronger risk management practices by the banking industry and represent international best practice in capital measurement and capital standards, the Administration proposed to implement Basel II in Hong Kong. Following consultation with the Panel on Financial Affairs (FA Panel), the banking industry and the public in 2004, the Administration introduced the Banking (Amendment) Bill 2005 (the Bill) into the Legislative Council (LegCo) on 22 February 2005 to provide for the implementation of Basel II and other miscellaneous matters.

7. The Bills Committee on Banking (Amendment) Bill 2005 (the Bills Committee) was formed by LegCo to scrutinize the Bill. The Bills Committee noted that the Bill did not contain any substantive rules for the implementation of Basel II. Instead, the Bill provided the Monetary Authority with a rule-making power to make rules prescribing the manner in which CARs of AIs should be calculated (“Capital Rules”) and rules prescribing public disclosure requirements for AIs on their financial affairs including CARs (“Disclosure Rules”). Both the Capital Rules and the Disclosure Rules would have the status of subsidiary legislation subject to the negative vetting of LegCo.

8. The Bills Committee expressed general support for the implementation of Basel II in Hong Kong. The Hansard on the resumption of the Second Reading debate on the Bill at the LegCo meeting on 6 July 2005 is in **Appendix I**.

² “1 January 2007” refers to the implementation date for the less advanced approaches to the calculation of capital charges for credit and operational risks. For the most advanced approaches, the Basel Committee has set the implementation date as 1 January 2008.

9. Following the passage of the Bill on 6 July 2005, HKMA proceeded with the drafting of the Capital Rules and Disclosure Rules, and will update the FA Panel on 4 May 2006 on the progress made.

Implementation of Basel II in Hong Kong

Main features of Basel II

10. Basel II is structured on three pillars, as follows:

- (a) Pillar 1 sets out the minimum capital requirements. It maintains the minimum CAR requirement of 8% but extends the requirement on a consolidated basis to holding companies of banking groups. The calculation of the minimum CAR will cover a bank's exposure to operational risk, in addition to credit risk and market risk;
- (b) Pillar 2 covers the supervisory review process of a bank. It requires a bank to put in place sound internal processes to assess the adequacy of its capital, based on a thorough evaluation of its risks, including those risks not covered under Pillar 1 such as interest rate risk in the banking book and reputational risk. Banks are expected to hold capital above the regulatory minimum and supervisors must intervene at an early stage if capital levels become insufficient; and
- (c) Pillar 3 is to complement Pillar 1 and Pillar 2 by promoting market discipline through public disclosure of key information on capital, risk exposures and risk assessment of a bank.

Implementation approach for Hong Kong

11. The current framework for regulating and measuring the CARs of AIs is provided in Part XVII of and the Third Schedule to the BO. These are supplemented by supervisory guidelines and technical notes issued by HKMA from time to time. As pointed out in paragraph 7 above, a rule-making approach was adopted under the Bill to empower the Monetary Authority to make the Capital Rules and Disclosure Rules. However, the Monetary Authority's power to make rules was subject to the statutory duty to consult the Banking Advisory Committee, Deposit-taking Companies Advisory Committee, Hong Kong Association of Banks, DTC Association, and the Financial Secretary. The Monetary Authority was also empowered to issue guidelines indicating the manner in which he proposed to exercise functions conferred on him under the Rules. Such guidelines are not subsidiary legislation.

12. Regarding the rationale for empowering the Monetary Authority to make the Capital Rules and Disclosure Rules instead of amending the current Third Schedule of the BO, the Administration explained to the Bills Committee that

given the fact that the method of calculating CARs under Basel II was considerably more complex than that currently specified in the Third Schedule to the BO, putting the revised regime into legislation through the existing approach, i.e. by incorporating all the detailed calculations in the Third Schedule, was neither practical nor cost-effective. In addition, to keep pace with both developments in the industry which impacted on CARs and international practices which would evolve over time, there would be a need on a continuing basis to revise and keep up-to-date the CAR regime in Hong Kong. These necessitated modification of the existing process for putting into legislation the revised capital regime in Hong Kong.

Major concern of the Bills Committee

13. As a check and balance measure, the Bills Committee considered that a mechanism should be provided for appeals against the decisions made by the Monetary Authority under the Capital Rules. Under the original two-tier appeals mechanism proposed by the Administration, an AI aggrieved by a decision of the Monetary Authority made in relation to it under the Capital Rules might apply to the Monetary Authority for a review of the decision, and might appeal to the Chief Executive in Council. On the first-tier of the appeals mechanism, the Bills Committee noted that the Administration's intention was to establish an internal procedure for handling requests for review of the Monetary Authority's decisions. On receipt of such a request, a review committee constituted by officials in HKMA who had not been directly involved in making the decision in question would be formed to review the decision. This procedure was in line with the normal approach adopted currently by the Monetary Authority for resolving matters with the banking industry.

14. On the second-tier of the appeals mechanism, the Bills Committee considered that since the Chief Executive in Council was primarily a body for policy making, it might not have the time and expertise required to deal with such appeal cases. The Administration should establish a specific appeal body for handling appeal cases relating to the decisions of the Monetary Authority made under the BO, as in the case of the Securities and Futures Ordinance (Cap. 571), where a Securities and Futures Appeals Tribunal had been established to handle appeals against the decisions of the Securities and Futures Commission. Given the technical nature of appeals under the Capital Rules, the Administration accepted the Bills Committee's view and agreed to set up an independent appeal body, the Capital Adequacy Review Tribunal.

15. As regards the extent to which the decisions of the Monetary Authority in relation to the Capital Rules would be subject to appeal, the Bills Committee was advised by the Administration that the right of appeal would only lie in respect of the fundamental decision as to which approach to capital adequacy calculation an AI might adopt, which might have a material impact on the AI's capital requirement. The detailed calculation technicalities, which were to be

prescribed in accordance with the international standards of Basel II, would not be subject to appeal. The Capital Rules would also specify which decisions of the Monetary Authority made in the exercise of the power conferred on it by the Capital Rules would be subject to appeal.

Reference

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

Council Business Division 1
Legislative Council Secretariat
3 May 2006

~~**PRESIDENT** (in Cantonese): Those against please raise their hands.~~

~~(No hands raised)~~

~~**PRESIDENT** (in Cantonese): I think the question is agreed by a majority of the Members present. I declare the motion passed.~~

~~**CLERK** (in Cantonese): Bankruptcy (Amendment) Bill 2004.~~

~~**Resumption of Second Reading Debate on Bills**~~

~~**PRESIDENT** (in Cantonese): We will resume the Second Reading debate on the Banking (Amendment) Bill 2005.~~

BANKING (AMENDMENT) BILL 2005

Resumption of debate on Second Reading which was moved on 6 April 2005

PRESIDENT (in Cantonese): Mr Jeffrey LAM, Chairman of the Bills Committee on the above Bill, will now address the Council on the Committee's Report on the Bill.

MR JEFFREY LAM: Madam President, in my capacity as Chairman of the Bills Committee on Banking (Amendment) Bill 2005, I would like to report on the deliberations of the Bills Committee.

The principal object of the Banking (Amendment) Bill 2005 (the Bill) is to amend the Banking Ordinance to provide a framework for incorporating the revised capital adequacy framework under Basel II.

Basel II, or the New Capital Accord, has been on the minds of central bank governors and regulators for several years. It is based on three mutually reinforcing pillars.

The first pillar aligns the minimum capital requirements more closely to banks' actual underlying risks. Qualifying banks will rely partly on their own measures of those risks, a rule that helps to create economic incentives for banks to improve those measures.

The second pillar refers to the supervisory review process. Each bank is required to assess the full range of risks and establish internal processes to assess its own capital adequacy on the basis of a thorough evaluation of all risks to which it is exposed. Banks are expected to hold capital above the regulatory minimum and supervisors must intervene at an early stage if capital levels became insufficient.

The third pillar aims to bolster market discipline through public disclosure. Each bank would be required to disclose publicly key information on its capital, risk exposures and risk assessment and management.

The proposed amendments to the Banking Ordinance for the purpose of implementing Basel II in Hong Kong basically relate to two major areas, namely capital adequacy ratio of authorized institutions and enhancement of the existing financial disclosure regime applicable to authorized institutions. However, the Bill does not contain any substantive rules of Basel II.

We notice that the current framework for regulating and measuring authorized institutions' capital adequacy ratios is embodied in Part 17 of and the Third Schedule to the Banking Ordinance. As the proposed implementation of Basel II would involve a significantly more sophisticated approach to the calculation of capital adequacy ratio as compared with the present regime in the Banking Ordinance, the Hong Kong Monetary Authority proposes to adopt a rule making approach to save the ongoing need to update the regime in keeping up with industry developments and international practices. To this effect, clause 2 of the Bill provides for the Monetary Authority to make rules prescribing public disclosure requirements for authorized institutions on their financial affairs including capital adequacy ratio (Disclosure Rules); and clause 4 of the Bill provides for the Monetary Authority to make rules prescribing the manner of calculation of the capital adequacy ratio of authorized institutions (Capital Rules).

Regarding the Capital Rules and Disclosure Rules to be promulgated, we understand that they are subsidiary legislation subject to negative vetting by the

Legislative Council, although it has not been stated in the Bill. We also note that the Bill also proposes to amend section 7(3) of the Banking Ordinance to allow the Monetary Authority to issue guidelines indicating the manner in which he proposes to exercise functions conferred on him under these Rules. Such guidelines are not subsidiary legislation.

We see the need to put in place a proper check and balance mechanism to ensure the fairness of the system. We therefore take the view that provisions on the mechanism for appeals and other procedural safeguards should be incorporated into the Banking Ordinance with regard to the decisions of the Monetary Authority made under the Capital Rules. To this end, the Administration proposes a two-tier appeals mechanism. At the first tier, under the new section 98A(3), the rules made under section 98A(1) may provide for the Monetary Authority, on application made to him by any person aggrieved by a decision made by the Monetary Authority under those rules, to review his decision. At the second tier, an authorized institution aggrieved by a decision made by the Monetary Authority under those rules can also appeal to the Chief Executive in Council for a review under the existing Banking Ordinance.

On the first-tier appeals mechanism, the Administration's intention is to establish an internal procedure for handling requests for review of the Monetary Authority's decisions. This procedure is in line with the normal approach adopted currently by the Monetary Authority for resolving matters with the banking industry. Hence, proposed section 98A(3) would formalize the existing informal procedure. To reflect the policy intention, the Administration also proposes to move a Committee stage amendment (CSA) to clause 4 to make it clear that an authorized institution, instead of "any person", aggrieved by a decision of the Monetary Authority made in relation to it under the Capital Rules could make an application for review of the Monetary Authority's decision.

We consider that the second-tier mechanism with the Chief Executive in Council being the appellate body, is not suitable for present-day circumstances. Since the Executive Council is primarily a body to assist the Chief Executive in policy making and that the Executive Council may lack the time and expertise required to deal with such appeal cases, the Administration should consider establishing a specific appeal body for handling appeal cases relating to the decisions of the Monetary Authority made under the Banking Ordinance, as in the case of the Securities and Futures Ordinance (Cap. 571), where a Securities

and Futures Appeals Tribunal had been established to handle appeals against the decisions of the Securities and Futures Commission.

The Administration points out that the existing appeals mechanism in the Banking Ordinance, that is, the Chief Executive in Council being the appellate body, has been in place for a long time and its appropriateness has not been questioned by the banking industry. Nevertheless, the Administration sees merit in members' proposal, given the technical nature of appeals under the Capital Rules, and agrees to move the CSAs to the Bill to provide for the establishment of a tribunal that would review certain decisions of the Monetary Authority made under the Capital Rules.

We have also examined the extent to which the decisions of the Monetary Authority in relation to the Capital Rules would be appealable under the proposed amendments in the Bill. The Administration points out that the right of appeal will only lie in respect of the fundamental decision as to which approach to capital adequacy calculation an authorized institution may adopt, which may have a material impact on the authorized institution's capital requirement. The detailed calculation technicalities, which are to be prescribed in accordance with the international standards of Basel II, would not be subject to appeal. The Capital Rules would be made after thorough industry consultation as proposed in clause 4 of the Bill.

At present, the Monetary Authority is empowered under section 101 of the Banking Ordinance to vary, after consultation with the Financial Secretary, the capital adequacy ratio of licensed banks to a maximum of 12% and that of deposit-making companies and restricted licence banks to 16%. Clause 5 recasts section 101(1) to empower the Monetary Authority to vary the capital adequacy ratio of all authorized institutions to a maximum of 16%. We note the Administration's view that such amendment is necessary to enable the Monetary Authority to set a higher capital adequacy ratio if the circumstances so require, for example, a significant increase in risks to which an individual bank or the industry as a whole is exposed.

The Bill also proposes a number of miscellaneous amendments to the Banking Ordinance, including amongst other things, limiting the liability of managers of companies, for some offences under the Banking Ordinance, to instances that are results of an act or omission on the part of the manager personally or of a person under his control. We agree that since a manager is

normally responsible for only one business area of an authorized institution, it is unreasonable that he or she may be prosecuted for a contravention committed outside his or her area of responsibility.

Madam President, the Administration has accepted the Bills Committee's suggestion to move the CSAs to the Bill to provide for the establishment of a tribunal that would review certain decisions of the Monetary Authority made under the Capital Rules. The Administration has also accepted members' suggestion to refine the CSAs to allow the tribunal to publish its determination and the reasons for the determination under certain circumstances.

With these remarks, we support the Bill and the CSAs to be moved by the Administration. Thank you.

PRESIDENT (in Cantonese): Does any other Member wish to speak?

MS EMILY LAU: Madam President, I rise to speak in support of the Second Reading of the Banking (Amendment) Bill 2005. I am not a member of the Bills Committee, but would like to put on record a couple of points on the new powers of the Hong Kong Monetary Authority (HKMA), points which were just made by the Honourable Jeffery LAM.

The proposed implementation of Basel II involves a significantly more sophisticated approach to the calculation of capital adequacy ratio, as compared with the present regime provided for in the Banking Ordinance.

The HKMA proposes to adopt a rule-making approach to obviate the need to constantly update the regime in order to keep pace with industry developments and international practices. Madam President, clause 2 of the Bill provides for the HKMA to make rules prescribing public disclosure requirements for authorized institutions. Clause 4 provides for the HKMA to make rules prescribing the manner of calculation of capital adequacy ratio of authorized institutions. When asked why a rule-making approach is better than amending the third Schedule of the Banking Ordinance, the Administration told the Bills Committee that because the method of calculating capital adequacy ratio under Basel II is considerably more complex than what is currently specified in the

third Schedule, so, putting the revised regime in legislation is neither practical nor cost-effective.

Furthermore, in order to keep pace with the developments in the industry and in international practices, there is a need to constantly revise and update the capital adequacy ratio regime. Thus, a more simple rule-making approach is preferred. The Bills Committee notes that both the capital rules and the disclosure rules to be promulgated are regarded as subsidiary legislation, subject to negative vetting by this Council. However, this is not stated in the Bill. The Bills Committee also notes that the Bill proposes to amend section 7(3) of the Banking Ordinance to allow the HKMA to issue guidelines indicating the manner in which it proposes to exercise the powers conferred on it under the rules. Members of the Bills Committee asked whether it should be spelled out clearly in the Bill that the capital rules and the disclosure rules are subsidiary legislation. The Administration said that this is not necessary because there should not be any doubt that this is so. Madam President, by highlighting this point at this Second Reading debate, I hope to put it beyond doubt that the rules are subsidiary legislation subject to negative vetting by this Council, and I am so pleased that Mr LAM made the same point earlier. I am sure that the Administration is very much aware of this.

The Bills Committee also notes that the HKMA's power to make rules is subject to the statutory duty to consult the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, the Hong Kong Association of Banks, the Deposit-taking Companies Association and the Financial Secretary. As to the guidelines to be issued by the HKMA, they are not subsidiary legislation, but there is a requirement that they should be published by notice in the Gazette.

Madam President, the Bill proposes to give the HKMA under Mr Joseph YAM more power and responsibility, and part of it is subject to the scrutiny of this Council. I hope that the HKMA, led by Mr YAM, will exercise these powers prudently, and will consult this Council and members of the financial community.

I would like to put on record my concern and observation, and hope that the Administration will take them into account. With these remarks, I support the Second Reading of the Bill.

PRESIDENT (in Cantonese): Does any other Member wish to speak?

(No Member indicated a wish to speak)

PRESIDENT (in Cantonese): If not, I now call upon the Secretary for Financial Services and the Treasury to reply.

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY:

Madam President, firstly, I would like to take this opportunity to express my heartfelt gratitude to the Honourable Jeffrey LAM, Chairman of the Bills Committee, and all other Bills Committee members for contributing their time and efforts to the scrutiny of this Bill in the past two months. I would also like to thank the Honourable Emily LAU, even though she was not a member of the Bills Committee, she did raise some very good points. I hope that the Honourable Emily LAU would join any of the banking bills committees in the future. The advice from Bills Committee members and the Honourable Emily LAU has been most helpful in bringing this legislative proposal to its final shape.

The main purpose of this Bill is to amend the Banking Ordinance to put in place a legislative framework for the implementation in Hong Kong of the revised international capital adequacy standards, promulgated by the Basel Committee on Banking Supervision in June 2004 and commonly known as "Basel II". I am most delighted that the Administration's proposal to implement Basel II in Hong Kong as soon as practicable has received the support of the Bills Committee in recognition that this would further consolidate our position as an international financial centre. Well, put it this way, as an international financial centre, we should have legislation that improves the risk-management capability of the banking sector. The Bill also contains a few proposals to enhance the operation of individual provisions of the Banking Ordinance in the light of experience, which also have received support from the Bills Committee.

While the Bills Committee has largely endorsed the policy objectives and detailed proposals of this Bill, some Members have suggested that the Administration should consider establishing a specific appeal body for handling appeal cases relating to the highly technical decisions made by the Monetary Authority under the new capital adequacy framework.

In response to this comment, the Administration has conducted a quick review in consultation with the banking industry. We note that the existing appeals mechanism to the Chief Executive in Council in the Banking Ordinance has been working well and is well received by the banking industry. We believe that this mechanism remains appropriate for the various appealable decisions under the Banking Ordinance which may have substantial implications on Hong Kong's financial stability. Yet, given the technical nature of appeals relating to decisions made under the new capital adequacy standards, we see merit in Members' proposal to set up an independent body with experts to review these cases. Hence we have accepted Members' view and have proposed Committee stage amendments (CSAs) to establish the Capital Adequacy Review Tribunal.

The provisions establishing this new tribunal are mostly modelled on provisions in other ordinances where similar tribunals are established, but they also address the banking industry's concern about confidentiality of sensitive business data. We accept the industry's view that inappropriate disclosure of information about an appeal or of the mere fact that an appeal is being made could undermine public confidence in the authorized institution concerned which may have impact on banking stability. Having consulted the Bills Committee, we have included appropriate provisions in the CSAs to preserve a certain degree of confidentiality of the new Tribunal's work.

Madam President, I will be moving CSAs shortly on the basis of the above consensus reached at the Bills Committee meetings. As the enactment of this Bill is important for the Hong Kong Monetary Authority to proceed with other preparatory work for the implementation of Basel II in Hong Kong, I hope all Members would support the Bill and any CSAs to be moved.

Lastly, I wish to thank all those parties who have provided comments on the Bill, and the Legislative Council Secretariat for the professional advice and efficient support given to us.

Thank you, Madam President.

Implementation of Basel II in Hong Kong

List of relevant papers
(Position as at 3 May 2006)

Meeting	Paper	LC Paper No.
FA Panel meeting on 5 July 2004	Paper provided by HKMA on ‘The New Capital Accord (“Basel II”)	CB(1)2254/03-04(03)
	Minutes of meeting (paragraphs 6 to 19)	CB(1)2513/03-04
FA Panel meeting on 6 December 2004	Paper provided by HKMA on ‘Briefing on “Basel II” and Proposed Legislative Amendments to the Banking Ordinance’	CB(1)365/04-05(04)
	“Background Brief on the proposed implementation of the New Basel Capital Accord in Hong Kong” prepared by the LegCo Secretariat	CB(1)365/04-05(05)
	Minutes of meeting (paragraphs 37 to 47)	CB(1)741/04-05
First meeting of the Bills Committee on Banking (Amendment) Bill 2005 on 27 April 2005	LegCo Brief on Banking (Amendment) Bill 2005 issued by the Financial Services and the Treasury Bureau on 2 March 2005	—
House Committee meeting on 17 June 2005	“Report of the Bills Committee on Banking (Amendment) Bill 2005” prepared by the LegCo Secretariat	CB(1)1780/04-05