立法會
Legislative Council

LC Paper No. CB(1)2360/10-11

Ref: CB1/PL/FA

Panel on Financial Affairs
Meeting on 9 June 2011

Background Brief
on the implementation of Basel II and Basel III in Hong Kong

Purpose

This paper sets out background information on the implementation of Basel II and Basel III in Hong Kong, and summarizes the major views and concerns expressed by Members when relevant proposals were deliberated at the relevant committees of the Legislative Council (LegCo).

Basel I

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 joined the Basel Committee as a member in June 2009.

3. Basel I refers to the supervisory approach stipulated in the Basel Capital Accord adopted in 1988. One of its key elements is the capital adequacy ratio (CAR), which 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 under Basel I was 8%.

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[1] The Basel Committee, established by the central-bank Governors of the Group of Ten countries at the end of 1974, meets regularly four times a year. It has four main working groups which also meet regularly. The Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank. The Committee's Secretariat is provided by the Bank for International Settlements in Basel.

Basel I and its subsequent amendments had been adopted and implemented 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 were set out in the Third Schedule to the BO and supplemented by supervisory guidelines and technical notes issued by the Hong Kong Monetary Authority (HKMA).

Basel II

Regulatory approach

4. In order to address the limitations of Basel I, 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 incentives for banks to enhance risk measurement and management capabilities, and to promote market discipline by means of improved disclosure. Basel II was published in June 2004 and, according to the then Basal Committee's timetable, was expected to be implemented globally with effect from 1 January 2007.

5. 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.

<u>Banking (Amendment) Bill 2005</u>

6. Given that Basel II would promote the adoption of stronger risk management practices by the banking industry and represented international best practice in capital measurement and capital standards, the Administration introduced the Banking (Amendment) Bill 2005 (the Bill) into LegCo on 22 February 2005 to provide for the implementation of Basel II. The Bill was passed on 6 July 2005. According to the amended BO, the Monetary Authority (MA) has the power to promulgate rules prescribing the manner in which authorized institutions (AIs)' CAR shall be calculated and information on financial affairs that AIs shall disclose. These rules, referred to as "Capital Rules" and "Disclosure Rules", are subsidiary legislation and are subject to negative vetting by the Legislative Council. The MA'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. The MA is also empowered to issue guidelines indicating the manner in which he proposes to exercise functions conferred on him under the rules. Such guidelines are not subsidiary legislation.

7. During its scrutiny of the Bill, the relevant Bills Committee sought explanation on the rationale for empowering the MA to make the Capital Rules and Disclosure Rules instead of amending the then Third Schedule to the BO, which set out how the minimum capital requirement should be calculated under the Basel I framework. The Administration explained that given the fact that the method of calculating CARs under Basel II was considerably more complex than that specified in the Third Schedule to the BO, putting the revised regime into legislation, 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 capital adequacy framework in Hong Kong.

8. Another major concern of the Bills Committee was the appeal mechanism in respect of the decisions made by the MA under the Capital Rules. Under the original two-tier appeal mechanism proposed by the Administration, an AI aggrieved by a decision of the MA made in relation to it under the Capital Rules might apply to the MA for a review of the decision, and might appeal to the Chief Executive in Council. On the first-tier of the appeal mechanism, the Bills Committee noted that the Administration's intention was to establish an internal procedure for handling requests for review of the MA'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.

9. 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 Bills Committee thus suggested that a specific appeal body should be established for handling appeal cases relating to the decisions made by the MA under the new capital adequacy framework. The Administration accepted the Bills Committee's view and moved Committee Stage amendments to provide for the establishment of the Capital Adequacy Review Tribunal for review of decisions made by HKMA under the Capital Rules in relation to the choice of approaches for the calculation of capital adequacy in respect of individual AIs.

Making of Capital Rules and Disclosure Rules

10. Following the enactment of the Banking (Amendment) Ordinance 2005, HKMA proceeded with the drafting of the Capital Rules and Disclosure Rules. On 4 May 2006, HKMA briefed the Panel on Financial Affairs (FA Panel) on the progress of HKMA's preparation for the implementation of Basel II in Hong Kong, including the making of the Capital Rules and Disclosure Rules. While the Panel noted that the banking sector in general was in support of the implementation proposals of Basel II, some AIs were concerned that the implementation timetable might be too aggressive. Panel members therefore urged HKMA to fully address AIs' concerns in developing the implementation plan. Some members also pointed out that some AIs might be reluctant to express their concerns in public as this might give the public an impression that their capital was inadequate to meet the requirements of Basel II. The members suggested that HKMA should arrange bilateral meetings with AIs to enable the latter to express their concerns at ease.

11. HKMA advised that the implementation approach and the timetable had been developed in close collaboration with the banking industry. HKMA was aware of the concerns of some AIs. For example, AIs which had noted slower implementation plans in their home jurisdictions preferred to have an implementation timetable in line with those of their home jurisdictions. To accommodate their respective needs, flexibility would be allowed for AIs to make minimum changes during the period from January 2007 and the implementation of Basel II in their home jurisdictions. HKMA also advised that it was prepared to meet with AIs individually to enable them to express their concerns at ease. At the

Panel's request, HKMA provided a supplementary information paper LC Paper No. CB(1)1887/05-06(01) on 28 June 2006 reporting on the outcome of the preliminary consultation with the banking industry on the proposed Capital Rules and Disclosure Rules and setting out the detailed plan for public consultation on the proposed Rules.

12. The Banking (Capital) Rules and Banking (Disclosure) Rules were published in the Gazette on 27 October 2006 and tabled in the Legislative Council for negative vetting on 1 November 2006. With the Rules coming into effect on 1 January 2007, Hong Kong was in the first wave of jurisdictions introducing the new Basel II standards.

Basel II Enhancements

13. In July 2009, the Basel Committee issued a set of enhancements to the Basel II framework to strengthen its risk coverage in the light of lessons drawn from the financial crisis. The main improvements include raising banks' capital requirements for trading book and securitization exposures, providing supplemental guidance on risk management principles and strengthening disclosure in corresponding areas. HKMA consulted the banking industry in September 2009 on the proposals to implement the Basel II enhancements in Hong Kong and, at the same time, introduced a number of refinements to the existing capital framework prompted largely by the implementation experience since its introduction in January 2007. As amendments to the Capital Rules and Disclosure Rules are necessary to reflect some of the Basel II enhancements, HKMA has been working with the Financial Services and the Treasury Bureau and the Department of Justice on preparing the legislative amendments.

14. In June 2010, the Basel Committee announced certain adjustments to the document "Revisions to the Basel II Market Risk Framework" and a new co-ordinated starting date of no later than 31 December 2011 for implementing the revisions.

Basel III and its implementation proposal

15. To enhance the resilience of the global banking system, the Basel Committee reached broad agreement on 12 September 2010 regarding "Basel III" and published the text of the Basel III regulatory framework in December 2010. The Basel III covers a tighter definition of regulatory capital and higher capital standards, including the following:

(a) the minimum common equity requirement will be increased from 2% to 4.5% and minimum Tier 1 capital from 4% to 6%;

(b) banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7%;

(c) a countercyclical buffer within a range of 0% to 2.5% of common equity will be implemented according to national circumstances; and

(d) the above capital requirements are supplemented by a non-risk based Tier 1 leverage ratio of 3%

16. Basel III also sets two minimum standards for funding liquidity and introduces a number of monitoring metrics for strengthening and promoting global consistency in liquidity risk supervision.

17. According to the Basel Committee's timetable, the Basel III requirements will be phased in from 1 January 2013 to 1 January 2019. According to its briefing notes provided to the FA Panel in May 2011, HKMA intends to follow this timetable and propose amendments to the BO so that the Monetary Authority is empowered to –

(a) make Rules, to give effect to banking supervisory standards relating to capital and liquidity issued by the Basel Committee from time to time (to replace the existing capital and liquidity ratios set out in the BO); and

(b) issue codes of practice to provide guidance in respect any of the provisions of the rules.

HKMA plans to submit a Banking (Amendment) Bill in December 2011 after industry consultation.

Deliberations of the Panel on Financial Affairs in recent years

18. In HKMA's regular briefings for the FA Panel on its work, HKMA provides updated information on the progress of its work for implementation of various Basel Committee initiatives. The Panel noted that as a result of the global financial crisis in 2007 and 2008, governments of the major developed economies had introduced a number of reform measures to tighten the control of the banking sector. Members were

concerned about the possible impact of such enhanced regulatory measures on the local banking sector, especially the medium and smaller sized banks. HKMA advised that the financial and banking sectors of Hong Kong had remained sound and robust in face of the challenges of the global financial crisis and the average consolidated capital adequacy ratio of locally incorporated AIs at end-December 2010 was 15.9%, which was well above the international standard of 8%. According to HKMA's work report in May 2010, it had revised its guidance on liquidity risk management standards to implement the Basel Committee's Principles for Sound Liquidity Risk Management and Supervision.

19. At the Panel meeting on 1 November 2010, a member enquired about the actions to be taken by HKMA to implement the Basel III requirements, and expressed concern whether the banking industry would have difficulty in complying with the Basel III requirements. HKMA responded that AIs should have no difficulty in complying with the tighter capital requirements set under Basel III because they had always been well-capitalised and maintained strong liquidity. The only area that Hong Kong might face some difficulties was in relation to the liquidity coverage ratio because there was a limited supply of public debt instruments in Hong Kong. As such, HKMA was discussing with the Basel Committee to identify alternative options to accommodate the situation of Hong Kong by the end of 2010.

Recent development

20. The Administration will brief the Panel on the progress of the implementation of Basel II enhancements and the proposals to implement Basel III at the Panel meeting on 9 June 2011.

Relevant papers

21. The relevant papers are available at the following links:

Banking (Amendment) Bill 2005	Report of Bills Committee to the Legislative Council and House Committee Hansard (page 9558-9573)
FA Panel meeting on 4 May 2006	Agenda Minutes (paragraphs 67-75) Follow-up paper (LC Paper No. CB(1)1887/05-06(01))

Papers provided by HKMA to the FA Panel for its briefings on the work of HKMA	2 February 2009 (slide 45) 21 May 2009 (slide 40) 19 November 2009 (slide 47) 1 February 2010 (slides 42 and 53) 20 May 2010 (slide 41) 1 November 2010 (slides 51 and 61) 1 March 2011 (slides 37-38) 23 May 2011 (slide 57)

Council Business Division 1
Legislative Council Secretariat
2 June 2011