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Panel on Financial Affairs

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Progress in Implementation of Basel II Enhancements and Plan to Implement Basel III

Hong Kong Monetary Authority

Outline of Presentation

I. Basel II

II. Lessons Learned from the Global Financial Crisis

III. Enhancements to Basel II
   - Progress in Implementation

IV. Basel III
   - Basel Committee on Banking Supervision ("BCBS") Implementation Timetable
   - Industry Feedback
   - Impact on Authorized Institutions in Hong Kong
   - Implementation Plan

Basel II

- Basel II implemented in Hong Kong since 1 January 2007
- Basel II is composed of 3 mutually reinforcing pillars:
  - Pillar 1: Minimum capital requirements for a bank's credit, market and operational risks;
  - Pillar 2: Supervisory review process to evaluate and monitor the bank's capital adequacy in relation to its overall risk profile; and
  - Pillar 3: Disclosure requirements to allow market participants to access key pieces of information on the bank's capital adequacy

Lessons Learned from the Global Financial Crisis

- Insufficient recognition of risks:
  - trading, re-securitisation and counterparty credit risk
- Build-up of excessive leverage
- Insufficient capital and liquidity buffers
- Procyclicality

Key Elements of Basel II Enhancements

- **Raise capital requirements for trading book and for complex securitisation exposures (Pillar 1):**
  - stressed value at risk and incremental risk charge for banks using internal models to calculate market risk
  - securitization exposures in trading book subject to higher capital requirements for securitization exposures in the banking book
  - higher capital requirements for "re-securitizations" in both trading book and banking book
- **Pillar 2 and Pillar 3 enhancements**
  - to address governance and risk management issues
  - to strengthen transparency re securitisation exposures

Basel II Enhancements – Implementation (1)

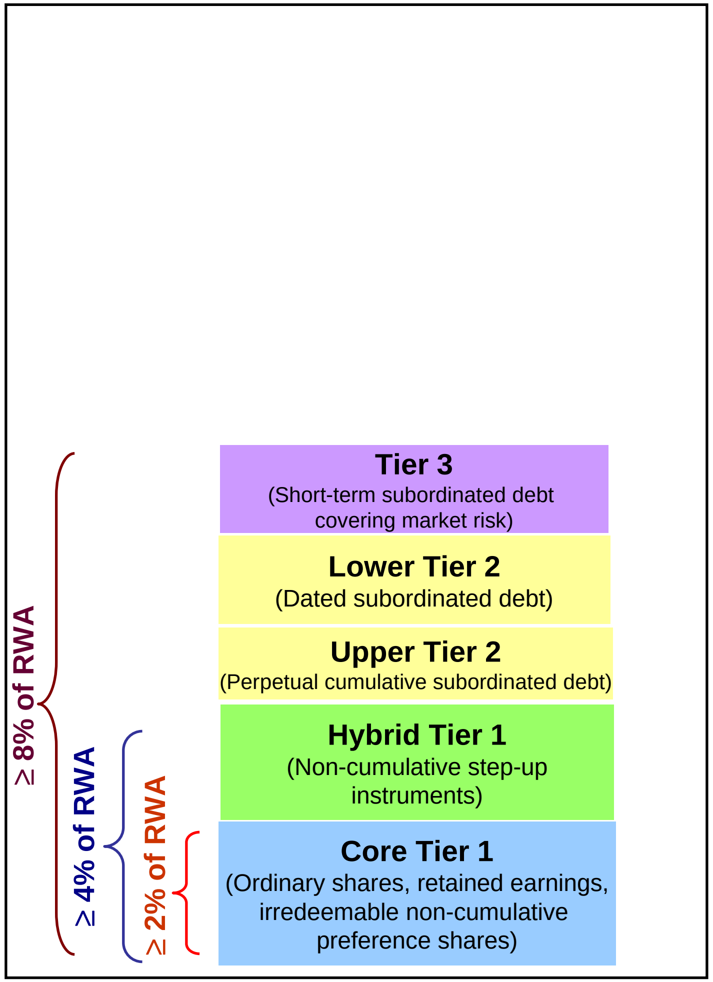
- National supervisors are expected to implement enhancements to Pillar 1 and Pillar 3 by end-2011
- Pillar 2 enhancements implemented since June 2010
- Consulted industry on content of proposed amendments to the Banking (Capital) Rules ("BCR") (Pillar 1) and Banking (Disclosure) Rules ("BDR") (Pillar 3) in Sep 09 and Aug 10
- Launched preliminary consultation on draft amendments to BCR and BDR on 12 May 11

Basel II Enhancements – Implementation (2)

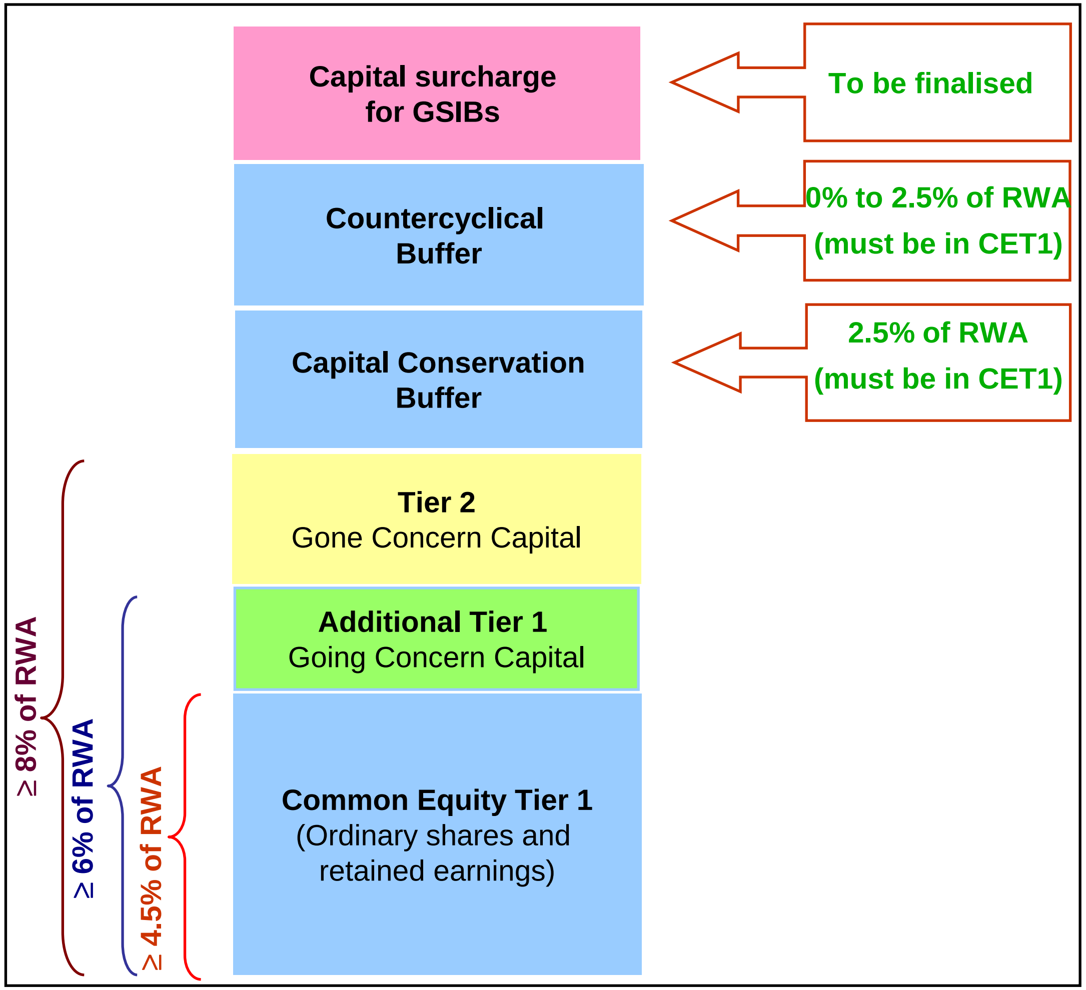
- Final text of amendments to BCR and BDR under preparation
- Statutory consultation on the Amendment Rules in Q3 2011
- Submission of the Amendment Rules to the Legislative Council ("LegCo") for negative vetting in Q4 2011
- Subject to LegCo's consideration, Amendment Rules to take effect from 1 January 2012 in line with the BCBS timetable

Definition of Capital

Basel II (Current)



Basel III (Future)



Key Elements of Basel III (1)

- **Raising the level, quality, consistency and transparency of capital**
  - higher minimum capital adequacy ratio requirements
  - more stringent harmonized eligibility criteria for regulatory capital
  - more disclosure
- **Limiting excessive leverage**
  - leverage ratio by reference to “total assets” rather than “risk weighted” assets

Key Elements of Basel III (2)

- **Addressing procyclicality**
  - **Conservation buffer**
    - to ensure that capital remains available to support ongoing business through periods of stress
  - **Countercyclical buffer**
    - to ensure additional capital defences built up in periods of excessive credit growth associated with the build-up of system-wide risk
    - National authorities to develop triggers for the build-up and release of buffer, using "credit-to-GDP" as a common starting reference point
  - Capital distribution constraints will be imposed when capital levels fall within the buffer range
- **Enhancing risk coverage**
  - strengthened capital requirements for counterparty credit risk

Key Elements of Basel III (3)

- **Setting global liquidity standards**
  - Sound Liquidity Risk Management Principles
  - Liquidity Coverage Ratio (LCR): to promote short-term liquidity resilience

$$\textbf{LCR} = \frac{\text{Stock of high-quality liquid assets}}{\text{Net cash outflows over 30-day period}} \geq \textbf{100\%}$$

  - Net Stable Funding Ratio (NSFR): to encourage more stable funding structures

$$\textbf{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \textbf{> 100\%}$$

Basel III - BCBS Implementation Timetable

From 1 January:

Shading indicates transition periods

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Min Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer						0.625%	1.25%	1.875%	2.5%
Min common equity + capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase in of deductions from Common Equity Tier 1				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital	4.0%	4.0%	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Min Total Capital + capital conservation buffer	8.0%	8.0%	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year period starting 2013						
Leverage ratio (3%)	Supervisory monitoring period		Parallel run period					Migration to Pillar 1	
Liquidity Coverage ratio	Observation Period								
Net Stable Funding ratio	Observation period								

Industry Feedback

- Banking industry provided comments on enhancements to Basel II and Basel III to BCBS and HKMA during consultation
- Generally supportive of underlying objectives of the reforms to promote resilience in banking sector
- However, highlighted the need to monitor combined effects and impact of the reform measures
- BCBS introduced observation period / extended transition period for implementation

Impact of Basel III Standards

- HK banks generally well-positioned to adopt the new capital standards
  - generally well-capitalised, with common equity as predominant element of capital base
- Do not anticipate major problems for local banks to comply with new liquidity standards
  - some banks may need to adjust their liquidity profiles or the composition of their liquid assets

Implementation Plan

- Propose to implement Basel II enhancements and Basel III following the BCBS timetable from 1 January 12 and 1 January 13 (in phases) respectively
- Amendments to existing BCR and BDR reflecting Basel II enhancements to be tabled at LegCo in Q4 2011
- Legislative amendments to enable Basel III implementation will begin this year: draft Banking (Amendment) Bill to be introduced into Legislative Council in the 2011-12 legislative session
- Amendments to BCR and BDR and any new Rules required to give effect to Basel III requirements to be prepared from Q3 2011 in phases

Hong Kong's Existing Regulatory Framework

- Currently in Banking Ordinance ("BO"), BCR and BDR, and supplemented by supervisory guidelines
- Part XVII of BO prescribes capital adequacy ratio for banks and empowers HKMA to make rules (subsidiary legislation) prescribing calculation methodologies
- Part XVIII of BO prescribes liquidity ratio for banks with the calculation methodologies set out in the Fourth Schedule (subsidiary legislation)
- Section 60A of BO empowers HKMA to make rules (subsidiary legislation) prescribing information to be disclosed re state of affairs, profit and loss or capital adequacy ratio

Draft Banking (Amendment) Bill 2011 (1)

- Basel III more complex than existing capital and liquidity requirements with: 4 capital ratios, 2 capital buffers and 2 liquidity ratios
- Global financial crisis demonstrated need for standards to be kept proactively under review and amended swiftly to address changes in business practices and financial environment
- To provide appropriate framework, propose to build upon existing rule making powers in the BO allowing HKMA to make rules prescribing capital requirements and associated disclosure requirements
- Introduce similar rule-making powers for liquidity requirements

Draft Banking (Amendment) Bill 2011 (2)

- Rules made by HKMA would set out ratios and buffer requirements
- Rules would be subsidiary legislation subject to statutory consultation and negative vetting
- Rules can be supplemented by codes of practice or technical memoranda to explain, and provide guidance on requirements and calculation methodologies
- Power for HKMA to vary capital / liquidity requirements – if satisfied on reasonable grounds it prudent to do so – after consultation and making of representations