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Panel on Financial Affairs

Meeting on 4 June 2012

**Background brief
on implementation of Basel regulatory requirements in Hong Kong**

Purpose

This paper sets out background information on the implementation of the Basel regulatory requirements 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

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.

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%. 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.

Banking (Amendment) Bill 2005

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 into LegCo on 22 February 2005 to provide for the implementation of Basel II. The Bill was passed on 6 July 2005.

7. According to the amended BO, the Monetary Authority ("MA") has the power to promulgate rules prescribing the manner in which the CAR of authorized institutions ("AIs") 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 LegCo. MA's power to make rules is subject to the statutory duty to consult the Banking Advisory Committee ("BAC"), the Deposit-taking Companies Advisory Committee ("DTCAC"), the Hong Kong Association of Banks ("HKAB"), the Deposit-taking Companies Association ("DTCA"), and the Financial Secretary. 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. A Capital Adequacy Review Tribunal should be established for review of decisions made MA under the Capital Rules in relation to the choice of approaches for the calculation of capital adequacy in respect of individual AIs.

8. During its scrutiny of the Bill, the relevant Bills Committee sought explanation on the rationale for empowering 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.

9. Another major concern of the Bills Committee was the appeal mechanism in respect of the decisions made by 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 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.

10. 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 be established for handling the appeal cases. The Administration accepted the Bills Committee's view and moved Committee Stage amendments to provide for the establishment of the Capital Adequacy Review Tribunal.

Making of Capital Rules and Disclosure Rules

11. 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 ("the 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.

12. 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. Some 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) in 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.

13. The Banking (Capital) Rules and Banking (Disclosure) Rules were published in the Gazette on 27 October 2006 and tabled in LegCo 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

14. In July 2009, the Basel Committee issued a set of enhancements to the Basel II framework (dubbed "Basel 2.5") 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. In June 2010, the Basel Committee further 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. HKMA consulted the banking industry in September 2009 and August 2010 on its implementation proposals covering the proposed amendments to the Capital Rules and Disclosure Rules, as well as its intention to put the amendments into effect starting from 1 January 2012.

15. The Banking (Capital) (Amendment) Rules 2011 and the Banking (Disclosure) (Amendment) Rules 2011 setting out the amendments to the Banking (Capital) Rules and Banking (Disclosure) Rules in relation to the implementation of Basel 2.5 were tabled in LegCo for negative vetting on 26 October 2011. No Subcommittee was formed in LegCo to study the amendment rules, and the amendment rules took effect on 1 January 2012.

Basel III

16. In December 2010, the Basel Committee issued two documents, namely, "Basel III: A global regulatory framework for more resilient banks and banking systems", and "Basel III: International framework for liquidity risk measurement, standards and monitoring" to set out the Basel III reform package for strengthening the global capital and liquidity requirements for banks. Through Basel III, the Basel Committee aims to improve the banking sector's ability to absorb shocks arising from financial and economic stress, thus reducing the risk of spill-over from the financial sector to the real economy. According to the Basel Committee's timetable, the Basel III requirements will be phased in from 1 January 2013 to 1 January 2019.

17. The main elements of Basel III include –

(a) Strengthening the global capital framework

- (i) Enhancing the quality of the regulatory capital base by tightening the qualifying criteria for instruments to be included in a bank's regulatory capital and harmonising regulatory deductions from the capital base;
- (ii) Increasing the minimum CAR requirements in relation to risk-weighted assets, with the common equity requirement rising from 2% to 4.5%; and the Tier 1 capital requirement rising from 4% to 6%; and
- (iii) Improving the transparency of the capital base.

(b) Reducing procyclicality

Basel III creates the capital conservation buffer (which is 2.5% of risk-weighted assets) and the countercyclical capital buffer (which ranges from 0% in normal times up to 2.5% of risk-weighted assets during periods of excessive credit growth associated with the build-up of system-wide risk) for banks' usage during periods of stress.

(c) Supplementing the risk-based capital requirements with a leverage ratio

Basel III introduces a simple leverage ratio, which is a ratio of Tier 1 capital to a bank's total exposures and is tentatively set

at 3%, to constrain the build-up of excessive leverage within the banking sector and provide an additional safeguard against model risk and measurement error in the risk-based capital adequacy calculation.

(d) Enhancing risk coverage

Basel III strengthens the capital requirements for certain counterparty credit risk exposures of banks through, amongst other things, the imposition of capital charges for mark-to-market losses, and the use of stressed inputs in the capital calculation.

(e) Introducing two minimum standards for funding liquidity

- (i) the **Liquidity Coverage Ratio**: this requires that a bank hold a stock of high-quality liquid assets that can be converted into cash to cover at least 100% of the bank's total net cash outflows over a period of 30 calendar days in times of stress; and
- (ii) the **Net Stable Funding Ratio**: this requires that the amount of stable funding available to a bank must be more than 100% of its required amount of stable funding over a one-year horizon under conditions of extended stress.

Discussion at the Panel on Financial Affairs

18. The Administration and HKMA briefed the Panel on 6 June 2011 on the implementation of Basel 2.5 and Basel III in Hong Kong. Members enquired about the possible impacts of implementing the Basel 2.5 and Basel III measures on the business development and competitiveness of AIs and their customers, in particular the small and medium sized enterprises, and the consequence of not implementing the Basel 2.5 and Basel III measures in Hong Kong.

19. The Administration responded that the objective of the Basel 2.5 and Basel III requirements was to enhance the resilience and risk management capability of AIs. While the more stringent capital and liquidity requirements would inevitably increase the operating costs of AIs, with enhanced resilience and risk management capability, AIs' funding costs and hence lending costs might be reduced. After the outbreak of the global financial crisis, international bodies such as the Financial Stability Board had put strong emphasis on regulatory reforms, and had been closely

monitoring the implementation of the reforms in different jurisdictions. If Hong Kong, as an international financial centre and a member of the Basel Committee on Banking Supervision, failed to implement the Basel II enhancements and Basel III requirements, Hong Kong might face the risk of being listed as a non-compliant jurisdiction and its future participation in international bodies might be jeopardized. AIs might be put in a disadvantageous position vis-à-vis their peers overseas if they did not follow international practices and comply with the latest supervisory requirements for the banking sector.

Banking (Amendment) Bill 2011

20. To provide for a framework for the implementation of Basel III in Hong Kong, the Administration introduced the Banking (Amendment) Bill 2011 into LegCo on 21 December 2011. The major proposals of the Bill include the following –

- (a) to remove the minimum capital and liquidity ratios from the main body of the BO and use subsidiary legislation to introduce the Basel III requirements into Hong Kong;
- (b) to introduce new provisions in the BO to empower MA to make rules to prescribe capital requirements for AIs incorporated in Hong Kong and liquidity requirements for all AIs, subject to the statutory duty imposed on MA to consult the Financial Secretary, BAC, DTCAC, HKAB and DTCA;
- (c) to empower MA to approve codes of practice for the purpose of providing guidance in respect of the rules prescribing capital requirements and liquidity requirements for AIs, and the rules prescribing the information to be disclosed to the general public by AIs relating to their financial affairs;
- (d) to broaden the scope of the Capital Adequacy Review Tribunal and designate it as the forum to hear appeals against decisions by MA to vary capital or liquidity requirements or require remedial actions by AIs when they have failed to comply with the capital or liquidity requirements applicable to them; and
- (e) to rename the Capital Adequacy Review Tribunal as the "Banking Review Tribunal" to reflected its broadened scope of functions.

21. No Bills Committee had been formed to scrutinize the Bill. A Member raised concern regarding the proposed use of rules to be made by MA to prescribe capital and liquidity requirements for AIs, instead of continuing the then existing arrangement of prescribing those regulatory requirements by way of primary legislation.² The Administration set out in its written reply the reasoning for the proposed approach in the Bill by reference to the technical nature of the rules, the need to respond to international requirements in a timely manner, the standing practice for LegCo scrutiny as well as similar treatment in local and overseas legislation³.

22. The Bill was passed by LegCo on 29 February 2012.

Recent developments

23. At the Panel meeting on 21 May 2012, HKMA informed the Panel that it had completed industry consultation on the first phase of policy proposals on Basel III in March 2012, and would conduct the second phase of policy proposals, which would cover disclosure requirements relating to the capital base and details of the liquidity standards. HKMA aimed at conducting statutory consultation in the third quarter of 2012 on the draft amendments to the Banking (Capital) rules and the Banking (Disclosure) Rules for the first phase implementation of Basal III on 1 January 2013. A member expressed concern that the implementation of Basel III requirements might result in over-regulation of the banking sector. HKMA responded that it would consult the industry on the implementation of Basel III requirements, and pointed out that the Basel Committee would conduct comprehensive evaluations of the implementation of Basel requirements by its members to ensure a level playing field among them.

24. The Administration and HKMA will brief the Panel on the development in implementing the regulatory requirements in Hong Kong under the Basel framework at the Panel meeting on 4 June 2012.

² The Member's concern was conveyed by the Legal Service Division of the LegCo Secretariat to the Administration vide LC Paper No. CB(1)1157/11-12(01).

³ The Administration provided its written reply vide LC Paper No. CB(2) 1192/11-12(01).

Relevant papers

25. 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 (pages 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))
FA Panel meeting on 9 June 2011	Agenda Minutes (paragraphs 39-45)
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) 15 December 2011 (slide 45) 2 March 2012 (slides 51 and 62)
Banking (Amendment) Bill 2011	Legislative Council Brief Report by Legal Service Division Letter from Legal Service Division to the Administration Administration's reply to Legal Service Division's letter Hansard (pages 6484- 6496)