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Paper for the House Committee

Report of the Subcommittee on Banking (Capital) (Amendment) Rules 2013 and Banking (Disclosure) (Amendment) Rules 2013

Purpose

This paper reports on the deliberations of the Subcommittee on Banking (Capital) (Amendment) Rules 2013 and Banking (Disclosure) (Amendment) Rules 2013 ("the Subcommittee").

Background

2. The international standards in the field of banking supervision are set by the Basel Committee on Banking Supervision ("the Basel Committee"). Hong Kong joined the Basel Committee as a member in June 2009. The Basel Committee has previously proposed regulatory frameworks commonly known as Basel I[1], Basel II[2] and Basel 2.5[3]. While Basel I and its subsequent amendments were implemented in Hong Kong through legislation under Part XVII of and the Third Schedule to the Banking Ordinance (Cap. 155) ("BO"), requirements under Basel II and Basel 2.5 frameworks were introduced in 2007 and 2012 respectively through the Banking (Capital) Rules (Cap. 155 sub. leg. L) and the Banking (Disclosure) Rules (Cap. 155 sub. leg. M) made by the Monetary Authority ("MA"). The two sets of rules are subsidiary legislation subject to the negative vetting procedure of the Legislative Council ("LegCo").

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1 Basel I refers to the supervisory approach stipulated in the Basel Capital Accord adopted in 1988. A key element is the introduction of the capital adequacy ratio.

2 Basel II refers to the supervisory approach stipulated in the New Basel Capital Accord published in 2004 to replace Basel I.

3 Basel 2.5 refers to a set of enhancements to the Basel II framework issued by the Basel Committee in 2009.

3. Building upon Basel 2.5, Basel III is a package of regulatory capital and liquidity standards designed to further enhance the resilience of banks and banking systems and address weaknesses observed in the global financial crisis in recent years. Basel III seeks to improve the banking sector's ability to absorb shocks arising from financial and economic stress, and to reduce the risks of any spillover from the banking sector to the real economy. The Basel III capital standards increase the level, quality and transparency of banks' capital base, as well as the risk coverage of the capital framework.

4. The Banking (Amendment) Bill 2011was passed by the LegCo on 29 February 2012 and gazetted as the Banking (Amendment) Ordinance 2012 (3 of 2012) ("BAO") on 9 March 2012. It provides for the legal framework for implementation of Basel III in Hong Kong[4]. The relevant sections of BAO which amend the powers of MA to make rules to prescribe the capital and disclosure requirements for authorized institutions ("AIs")[5], and the Banking (Capital) (Amendment) Rules 2012, came into operation on 1 January 2013 to implement the first phase of the new Basel III capital framework in Hong Kong[6]. In essence, the Banking (Capital) (Amendment) Rules 2012 have revised the minimum capital ratio requirements applicable to AIs, tightened the criteria for instruments to be recognized as regulatory capital, and extended the risk coverage of the capital framework in relation to counterparty credit risk ("CCR") to capture potential loss due to changes in the credit quality of a counterparty (referred to as credit valuation adjustment ("CVA") risk); and exposures to central counterparties ("CCPs").

5. On 12 April 2013, the Government gazetted the Banking (Capital) (Amendment) Rules 2013 and the Banking (Disclosure) (Amendment) Rules 2013 to respectively amend the Banking (Capital) Rules to clarify principally certain capital treatments for CCR and exposures to CCPs, and the Banking (Disclosure) Rules to prescribe revised requirements regarding disclosure by AIs of their capital adequacy and associated relevant financial information for the first phase implementation of Basel III capital standards. The two sets of amendment rules were tabled at the LegCo on 17 April 2013, and will come into operation on 30 June 2013.

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4 The Administration introduced the Banking (Amendment) Bill 2011 into LegCo on 21 December 2011. No Bills Committee was formed for scrutiny of the Bill.

5 Authorized institutions refer to licensed banks, restricted licence banks, and deposit-taking companies authorized under the BO.

6 The Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012 appointed 1 January 2013 as the day on which the amended powers of MA to make rules to prescribe capital and disclosure requirements for AIs for implementation of Basel III would come into operation. The Banking (Capital) (Amendment) Rules 2012 amends the Banking (Capital) Rules to revise the minimum capital ratio requirements and the definition of regulatory capital, and to enhance the counterparty credit risk framework.

The Subcommittee

6. At the House Committee meeting held on 19 April 2013, Members agreed to form a subcommittee to study the two sets of amendment rules. The membership list of the Subcommittee is in **Appendix I**. Under the chairmanship of Hon NG Leung-sing, the Subcommittee held one meeting and received written views from four organizations, the list of which is in **Appendix II**.

Deliberations of the Subcommittee

7. The Subcommittee supports the two sets of amendment rules which are necessary for the implementation of the first phase of Basel III requirements in Hong Kong. Members further note the Administration's confirmation that the amendments in the rules are fully consistent with the Basel III disclosure and capital standards and that no material modifications or deviations have been made. The major deliberations of the Subcommittee are set out in the ensuing paragraphs.

<u>Rationale for making and major elements in the two sets of amendment rules</u>

8. Noting that the Banking (Capital) (Amendment) Rules 2012 which revised the minimum capital ratio requirements and the definition of regulatory capital of AIs, as well as enhanced AIs' CCR framework for the implementation of the first phase Basel III requirements already took effect on 1 January 2013, the Subcommittee has examined the rationale for introducing the Banking (Capital) (Amendment) Rules 2013 and the Banking (Disclosure) (Amendment) Rules 2013 and the purposes of the major amendments.

9. The Administration explains that the Banking (Capital) (Amendment) Rules 2013 are made by MA under section 97C of the BO. It is necessary to make the Rules to further amend the Banking (Capital) Rules for clarifying certain capital treatments for CCR and exposures to CCPs as contained in the latest technical guidance documents released by the Basel Committee in November and December 2012 since these latest clarifications were too late to be accommodated in the Banking (Capital) (Amendment) Rules 2012. The clarifications relate mainly to the –

(a) recognition of the credit risk mitigating effect of recognized credit derivative contracts cleared through CCPs and clarification of the treatment of collateral posted by AIs to CCPs;

(b) clearer specification of the conditions and methods for recognizing hedging instruments as eligible for the purpose of reducing the new CVA capital charge, and clarification of the conditions to be met for defaulted exposures to be exempted from the CVA capital charge requirements; and

(c) treatment for certain types of collateral in the calculation of capital charges for exposures to CCPs.

Moreover, the amendments include technical refinements to clarify the operation of certain provisions in relation to the treatment of credit risk mitigation in the calculation of the capital charge for CVA risk and exposures to CCPs; and the calculation of the market risk capital charge for credit derivative contracts booked in AIs' trading books, as well as a few related miscellaneous amendments.

10. The Subcommittee notes that the further amendments in the Banking (Capital) (Amendment) Rules 2013 have reflected the requirements set out in the documents entitled "Basel III counterparty credit risk and exposures to central counterparties – Frequently asked questions" published by the Basel Committee in December 2012, and "International Convergence of Capital Measurement and Capital Standards – A Revised Framework (Comprehensive Version)" published by the Basel Committee in June 2006 ("ICCMCS 2006").

11. As regards the Banking (Disclosure) (Amendment) Rules 2013, the Administration advises that the purposes are to introduce corresponding and consequential amendments to the Banking (Disclosure) Rules to enhance the consistency and comparability of banks' disclosures in respect of their capital base; as well as to specify disclosure requirements relating to the internal models approach to the calculation of capital requirements for CCR, which were introduced by the Banking (Capital) (Amendment) Rules 2012. The amendments also include some recently updated disclosure standards from the Basel Committee to promote sound risk management practices in banks. The Subcommittee notes that the major Basel III disclosure standards require -

(a) a detailed breakdown of the full list of regulatory capital elements including all regulatory adjustments and the phase-in of such adjustments;

(b) a reconciliation of all regulatory capital elements back to the audited financial statements to help explain: (i) any differences in the scope of consolidation for accounting purposes and for regulatory purposes; and (ii) the relationship between balance sheet items and regulatory capital elements;

(c) a description of all limits and minima applied to the calculation of capital base;

(d) a description of the main features of regulatory capital instruments issued;

(e) provision of the full terms and conditions of regulatory capital instruments included in regulatory capital on a bank's website; and

(f) identification of specific components of capital, including regulatory capital instruments and regulatory adjustments, that benefit from the transitional arrangements included in the Basel Committee timeline for the introduction of Basel III.

12. The Subcommittee notes that the amendments in the Banking (Disclosure) (Amendment) Rules 2013 have reflected the disclosure requirements set out in Table 8 in ICCMCS 2006 and the document entitled "Composition of capital disclosure requirements – Rules text" published by the Basel Committee in June 2012.

<u>Impacts of the two sets of amendment rules on banks in Hong Kong</u>

13. The Subcommittee notes that some AIs, in particular the small and medium-sized ones, have previously expressed concern about possible impacts of the implementation of the new Basel III requirements on their operation. Members have enquired about the implementation experience of the first phase of Basel III requirements in Hong Kong since January 2013, and whether AIs would encounter challenges in meeting the requirements prescribed in the two sets of amendment rules.

14. The Hong Kong Monetary Authority ("HKMA") advises that implementation of the first phase of Basel III requirements in Hong Kong has been smooth. According to the results of a recent test run conducted by HKMA for all locally-incorporated AIs to report their capital positions substantially based on the capital standards under Basel III, all participant AIs were able to meet the Basel III capital requirements without difficulty. It was also revealed in the test run that all AIs in Hong Kong had maintained their minimum capital ratio requirements which far exceeded those required under the first phase of Basel III capital framework.

15. Regarding the impact of the amendment rules on the banking sector, the Administration points out that the Banking (Disclosure) (Amendment) Rules 2013 prescribe the disclosure requirements by AIs in respect of their capital base under the Basel III capital framework which already took effect on 1 January 2013 and thus will not result in additional capital costs on AIs. The enhanced disclosure requirements in the Banking (Disclosure) (Amendment) Rules 2013 will help promote the exercise of market discipline in relation to the risk-taking activities of banks and hence should contribute to the promotion of sound risk management and the overall stability of the banking system. Moreover, given that the industry has been engaged in the formulation of the new disclosure requirements for some time, it is not anticipated that the proposed amendments will create any undue compliance burden for AIs. As regards the amendments to the CCR framework and the calculation of market risk as prescribed in the Banking (Capital) (Amendment) Rules 2013, which are mostly miscellaneous technical refinements, they are not expected to have a significant impact on AIs' capital positions.

16. Regarding the small and medium-sized AIs, the Administration explains that it is unlikely that their operations will be affected as the Banking (Capital) (Amendment) Rules 2013 mainly relate to capital treatments for CCR and exposures to CCPs which will affect the transactions of over-the-counter derivatives the majority of which are conducted by large AIs.

<u>Consultation with the banking sector and the public on the two sets of amendment rules</u>

17. The Subcommittee is keen to ensure that there has been due consultation with the relevant stakeholders on the amendment rules. HKMA stresses that it has closely engaged the industry in a consultative process to formulate the two sets of amendment rules. In addition, in accordance with sections 60A and 97C of the BO, HKMA issued a draft of the provisions of the two sets of rules to consult the Financial Secretary, the Banking Advisory Committee ("BAC"), the Deposit-taking Companies Advisory Committee ("DTCAC"), The Hong Kong Association of Banks ("HKAB"), and The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies (DTCA) in November 2012 and March 2013, before finalizing the amendments. Responses indicated support for the amendments. Relevant technical or drafting comments were addressed in the finalized rules as appropriate, and the intent of certain provisions was clarified.

18. The Subcommittee has written to the four relevant banking organizations mentioned in paragraph 17 above and posted a notice in the LegCo website to respectively invite the organizations and the public to provide

written submissions on the amendment rules. Members note the replies from BAC and DTCAC that they are supportive of the two sets of amendment rules. HKAB has also expressed support on the principle of adopting Basel III standards in Hong Kong to reinforce Hong Kong's position as an international banking and financial centre and confirmed that the association has been consulted on the amendments and that its views and comments have been taken into account in the finalized version of the amendment rules. The DTCA has indicated that its members do not have any views on the amendment rules. No submissions have been received from the public on the amendment rules.

Technical and drafting matters

19. The Legal Adviser of the Subcommittee has made enquiries concerning certain technical and drafting matters on the two sets of amendment rules, which have been addressed by the Administration. The Subcommittee does not consider it necessary to follow up on those matters.

Advice sought

20. The Subcommittee will not move amendments to the two sets of amendment rules. The Chairman of the Subcommittee has made a verbal report on the deliberations of the Subcommittee at the House Committee meeting on 10 May 2013.

21. Members are invited to note the contents of this report.

Council Business Division 1
Legislative Council Secretariat
16 May 2013

Appendix I

Subcommittee on Banking (Capital) (Amendment) Rules 2013 and Banking (Disclosure) (Amendment) Rules 2013

Membership list

Chairman	Hon NG Leung-sing, SBS, JP
Members	Hon WONG Ting-kwong, SBS, JP Hon Alan LEONG Kah-kit, SC Hon Christopher CHEUNG Wah-fung, JP Hon SIN Chung-kai, SBS, JP Hon CHUNG Kwok-pan
	(Total： 6 members)
Clerk	Ms Connie SZETO
Legal Adviser	Mr Bonny LOO

Appendix II

Subcommittee on Banking (Capital) (Amendment) Rules 2013 and Banking (Disclosure) (Amendment) Rules 2013

List of organizations that have given views to the Subcommittee

1. The Hong Kong Association of Banks
2. The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies
3. The Banking Advisory Committee
4. The Deposit-taking Companies Advisory Committee