立法會
Legislative Council

LC Paper No. CB(1)114/12-13(01)

Ref : CB1/SS/1/12

Subcommittee on Banking (Capital) (Amendment) Rules 2012, Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 and Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012

Background brief on the implementation of Basel III

Purpose

This paper provides background information on the Banking (Capital) (Amendment) Rules 2012 ("the Capital Amendment Rules"), Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 ("the Amendment Notice") and Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012 ("the Commencement Notice") which were gazetted on 19 October 2012 for the first phase implementation of Basel III in Hong Kong. The paper also summarizes the discussions of relevant issues at meetings of the Panel on Financial Affairs ("the FA Panel") in the 2011-2012 session.

Basel III

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

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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.

amendments were implemented in Hong Kong through legislation under Part XVII of and the Third Schedule to the Banking Ordinance ("BO") (Cap. 155), 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 (Disclose) Rules (Cap. 155 sub. leg. M) made by the Monetary Authority ("MA"). The two sets of rules are subsidiary legislation subject to negative vetting of the Legislative Council ("LegCo").

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 recent global financial crisis. 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. It increases the level, quality and transparency of banks' capital base, as well as the risk coverage of the capital framework. It sets three minimum risk-weighted capital ratios, two new capital buffers to reduce the procyclicality of the capital framework, a non risk-weighted leverage ratio, and two minimum standards for banks' liquidity. It also strengthens the capital requirements for certain counterparty credit risk exposures of banks.

4. Basel III was endorsed by the G20 Leaders in November 2010, and they are committed to implementing Basel III fully in line with the Basel Committee's transitional timeline with the implementation beginning in January 2013 and phasing in the standards over the subsequent six years to achieve full implementation by 1 January 2019.

Banking (Amendment) Ordinance 2012

5. The Administration introduced the Banking (Amendment) Bill 2011 into LegCo on 21 December 2011 to provide for a framework for implementation of Basel III in Hong Kong. No Bills Committee had been formed for scrutiny of the Bill which was passed by LegCo on 29 February 2012 and gazetted as the Banking (Amendment) Ordinance 2012 ("BAO") on 3 March 2012. The major elements of BAO include the following:

(a) to remove the minimum capital and liquidity ratios from the main body of BO and use subsidiary legislation to introduce the Basel III requirements into Hong Kong;

(b) to introduce new provisions in BO to empower MA to make rules to prescribe capital requirements for authorized institutions

("AIs")[4] incorporated in Hong Kong and liquidity requirements for all AIs, subject to the statutory duty imposed on MA to consult the Financial Secretary, the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, the Hong Kong Association of Banks and the Deposit-taking Companies Association;

(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 reflect its broadened scope of functions.

The legislative proposals

<u>The Commencement Notice</u>

6. The Commencement Notice has been made by the Secretary for Financial Services and the Treasury under section 1(2) of BAO to appoint 1 January 2013 as the day on which certain provisions of BAO will come into operation. These BAO provisions amend the powers of MA to make rules to prescribe capital requirements for AIs in Hong Kong and disclosure requirements[5] for AIs, and confer powers on MA to approve codes of practice to provide guidance in respect of those rules. These provisions further prescribe the procedure for remedial action to be taken by an AI which has contravened the requirements, and provide for the Banking Review Tribunal to review certain decisions made by MA in this connection.

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

5 According to the Administration, MA intends to make the Banking (Disclosure) (Amendment) Rules 2013, in the form of subsidiary legislation, in the first quarter of 2013 to prescribe the disclosure requirements associated with the new capital requirements. The relevant disclosure requirements will take effect from 30 June 2013 in order to align with the latest implementation timetable promulgated by the Basel Committee.

The Capital Amendment Rules

7. The Capital Amendment Rules, which have been made by MA under section 97C of BO as amended by BAO, amend the Banking (Capital) Rules for implementation of Basel III capital requirements. The major amendments include amendments to the minimum capital ratio requirements and the definition of regulatory capital, enhancements to the counterparty credit risk framework, and other technical amendments. Details of the amendments are set out in paragraphs 14 to 21 of the LegCo Brief (File Ref: G4/16/44C) dated 17 October 2012 issued by the Administration, and paragraph 6 of the report (LC Paper No. LS5/12-13) dated 24 October 2012 issued by the Legal Service Division of the LegCo Secretariat. The Capital Amendment Rules will come into operation on 1 January 2013.

The Amendment Notice

8. According to the Administration, the Basel Committee made a decision in May 2010 to include the Multilateral Investment Guarantee Agency ("MIGA"), which is a member of the World Bank Group, in the list of "multilateral development banks"[6] for the purpose of the Basel capital framework. The Amendment Notice was made by MA to update the list of "multilateral development banks" to reflect the above decision of the Basel Committee, so that supervisors may allow banks to apply a 0% risk-weight to claims on MIGA. The Amendment Notice will come into operation on 1 January 2013.

Discussions at the Panel on Financial Affairs

9. Issues related to the implementation of Basel III standards in Hong Kong were discussed at meetings of the FA Panel held on 21 May and 4 June 2012. Members expressed concerns that implementation of Basel III requirements might result in over-regulation of the banking sector and additional costs on AIs, and small and medium-sized AIs might encounter difficulties in complying with Basel III standards.

[6] Under section 2(19) of BO, MA may by notice published in the Gazette specify to be a multilateral development bank for the purposes of BO any bank or lending or development body established by agreement between, or guaranteed by, two or more countries, territories or international organizations other than for purely commercial purposes. Exposures to multilateral development banks will be treated more favourably for the purposes of calculating the capital adequacy ratio and liquidity ratio of an AI under BO and the Banking Capital Rules.

10. The Hong Kong Monetary Authority ("HKMA") advised that it would consult the industry on the implementation of Basel III requirements and the Basel Committee would conduct comprehensive evaluations of the implementation of Basel requirements by its members to ensure a level playing field among them. On the cost impact on AIs, HKMA explained that since the capital adequacy ratio for banks in Hong Kong had been maintained at a very high level (standing at 15.8% at the end of 2011 which well exceeded the statutory requirement of 8%), banks in Hong Kong should have no difficulty in complying with the new requirements. On the other hand, strong capital adequacy might help reduce banks' cost for raising additional capital. HKMA added that as revealed by the findings of the bi-annual Quantitative Impact Studies conducted by HKMA on banks, the small and medium-sized banks in Hong Kong had no difficulty in complying with Basel III requirements.

11. As regards the progress of implementing Basel III standards in Hong Kong vis-à-vis overseas jurisdictions in this aspect, the Administration advised that Hong Kong would follow the timeframe set by the Basel Committee in implementing Basel III requirements, and aimed to enforce the capital standards starting from 1 January 2013. The Administration added that it was a statutory requirement for HKMA to consult the relevant banking and deposit-taking company associations in introducing the subsidiary legislation for implementation of Basel III standards.

Relevant papers

12. A list of relevant papers is in the **Appendix**.

Council Business Division 1
Legislative Council Secretariat
2 November 2012

Appendix

List of relevant papers

Date	Event	Papers/Minutes of meeting
21 May 2012	Briefing by the Hong Kong Monetary Authority to the Panel on Financial Affairs on its work	Power-point presentation materials by HKMA (LC Paper No. CB(1)2080/11-12(01)) Minutes of meeting (LC Paper No. CB(1)2267/11-12)
4 June 2012	The Panel on Financial Affairs was briefed on the progress of the implementation of Basel III standards in Hong Kong	Discussion paper (LC Paper No. CB(1)2035/11-12(04)) Background brief prepared by the Legislative Council Secretariat (LC Paper No. CB(1)2034/11-12) Minutes of meeting (LC Paper No. CB(1)2574/11-12)
24 October 2012	The Banking (Capital) (Amendment) Rules 2012, Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 and Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012 were tabled in the Legislative Council	Legislative Council Brief (File Ref: G4/16/44C) Legal Service Division Report (LC Paper No. LS5/12-13)

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