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Subcommittee on Banking (Disclosure) (Amendment) Rules 2016 and Banking (Specification of Class of Exempted Charges) (Amendment) Notice 2016

Background brief on implementation of Basel III in Hong Kong

Purpose

This paper provides background information on the Banking (Disclosure) (Amendment) Rules 2016 and the Banking (Specification of Class of Exempted Charges) (Amendment) Notice 2016 which were gazetted on 30 December 2016. The paper also summarizes the discussions of relevant issues by committees of the Legislative Council ("LegCo") from the session of 2011- 2012 to 2016 - 2017.

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 amendments were implemented in Hong Kong through legislation under Part XVII of and the Third Schedule to the Banking Ordinance ("BO")

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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 on Banking Supervision in 2009.

(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 (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 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 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 ("CCR") exposures of banks.

4. According to the Basel Committee's timeline, Basel III requirements are to be implemented in phases beginning in January 2013 with full implementation by 1 January 2019.

Implementation of Basel III in Hong Kong

<u>First phase of Basel III implementation</u>

5. The Banking (Amendment) Ordinance 2012 ("BAO") was enacted in February 2012 to provide 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 for implementing the first

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[4] The Government introduced the Banking (Amendment) Bill 2011 into the Legislative Council on 21 December 2011. No Bills Committee was formed for scrutiny of the Bill.

[5] Authorized institutions ("AIs") refer to licensed banks, restricted licence banks, and deposit-taking companies authorized under the Banking Ordinance (Cap. 155)("BO").

phase of the 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 CCR to capture potential loss due to changes in the credit quality of a counterparty and exposures to central counterparties ("CCPs").

6. The Government also tabled the Banking (Capital) (Amendment) Rules 2013 and the Banking (Disclosure) (Amendment) Rules 2013 at LegCo on 17 April 2013.[7] The former further amended the Banking (Capital) Rules to clarify principally certain capital treatments for CCR and exposures to CCPs while the latter amended 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 standards. Both pieces of subsidiary legislation came into operation on 30 June 2013.

<u>Second phase of Basel III implementation</u>

7. The second phase of Basel III implementation covers the introduction of a series of capital buffers, a liquidity coverage ratio, and the relevant disclosure requirements arising from such requirements. These standards seek to enhance AIs' liquidity risk requirements and their ability to absorb shocks in time of financial and economic stress.

8. The Government tabled the Banking (Amendment) Ordinance 2012 (Commencement) Notice 2014, the Banking (Capital) (Amendment) Rules 2014, and the Banking (Liquidity) Rules at LegCo on 29 October 2014. The

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[6] The Subcommittee on Banking (Capital) (Amendment) Rules 2012, Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 and Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012 was formed to scrutiny the three pieces of subsidiary legislation. The Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012 appointed 1 January 2013 as the day on which the amended powers of the Monetary Authority ("MA") to make rules to prescribe capital and disclosure requirements for AIs for implementation of Basel III would come into operation. The Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 is to reflect the Basel Committee's decision in May 2010 to include the Multilateral Investment Guarantee Agency in the list of "multilateral development banks" for the purpose of the Basel capital framework.

[7] The Subcommittee on Banking (Capital) (Amendment) Rules 2013 and Banking (Disclosure) (Amendment) Rules 2013 was formed to scrutinize the two pieces of subsidiary legislation.

first piece of subsidiary legislation brought into effect the provisions of BAO relating to the powers of MA to make rules prescribing liquidity requirements for AIs. The second set of subsidiary legislation introduced the Capital Conservation Buffer and the Countercyclical Capital Buffer for AIs, and a Higher Loss Absorbency Requirement for AIs which were considered systemically important. It also imposed constraints on an AI's distribution payments where the AI's Common Equity Tier 1 capital ratio was equal to or below its buffer level. The third set of subsidiary legislation introduced the Basel III Liquidity Coverage Ratio ("LCR") requirement on relevant types of AIs.[8] The above three set of subsidiary legislation commenced operation on 1 January 2015.[9] The Banking (Disclosure) (Amendment) Rules 2014 were tabled at LegCo on 7 January 2015 to make corresponding amendments to the Rules to prescribe the disclosure requirements in relation to the capital buffers, LCR and leverage ratio of AIs.[10] The Amendment Rules came into operation on 31 March 2015.

9. With a view to introducing miscellaneous refinements to align certain aspects of the Banking (Capital) Rules more closely with the relevant standards issued by the Basel Committee, the Government tabled the Banking (Capital) (Amendment) Rules 2015 at LegCo on 28 October 2015 which came into operation on 1 January 2016.[11]

The Banking (Disclosure) (Amendment) Rules 2016 and the Banking (Specification of Class of Exempted Charges) (Amendment) Notice 2016

10. The Banking (Disclosure) (Amendment) Rules 2016 amends the Rules to implement the requirements for disclosures by AIs set out in the Basel Committee's document entitled "Revised Pillar 3 disclosure requirements" issued in January 2015. Under the Pillar 3 disclosure requirements, banks have to make public disclosure of key information on their capital, liquidity, and risk exposure to facilitate risk assessment and enhance market disciplines. The latest Pillar 3 disclosure requirements aim to improve the comparability

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[8] Under the Banking (Liquidity) Rules, the Basel III Liquidity Coverage Ratio requirement are imposed on AIs designated by MA as internationally active or significant to the general stability and effective working of the banking system in Hong Kong. As for other AIs, the less stringent Liquidity Maintenance Ratio requirement will apply.

[9] No subcommittee was formed for scrutiny of the subsidiary legislation concerned.

[10] No subcommittee was formed for scrutiny of the subsidiary legislation concerned.

[11] No subcommittee was formed for scrutiny of the subsidiary legislation concerned.

and consistency of disclosure between banks and across jurisdictions. The major amendments introduced are set out in paragraph 11 of the LegCo Brief (File Ref: B&M/2/1/63C dated 28 December 2016), and paragraph 2 of the report (LC Paper No. LS22/16-17) issued by the Legal Service Division of LegCo Secretariat.

11. The Banking (Specification of Class of Exempted Charges) (Amendment) Notice 2016 amends the Banking (Specification of Class of Exempted Charges) Notice (Cap. 155 sub. leg. K) by adding a new exempted class of charges which are created in connection with the relevant AI's provision of initial margin for over-the-counter ("OTC") derivative transactions so that such class of charges is exempted from the prohibition under section 119A(2) of BO up to a value equivalent to 5% of an AI's total assets. Under section 119A(2) of BO, except with the approval of MA, an AI is prohibited from creating any charge over its assets under certain circumstances, such as when the aggregate value of all existing charges over its total assets (excluding contra items) is 5% or more of the value of its total assets. Under section 119A(3) of BO, MA may by notice published in the Gazette specify certain charges or classes of charges to which section 119A(2) does not apply. According to the Government, the amendment in the 2016 Notice aims to strike a balance between facilitating AIs' compliance with the latest margin and risk mitigation standards promulgated by the Basel Committee and the International Organisation of Securities Commissions for OTC derivatives that are not cleared through CCP on the one hand and preserving the integrity of section 119A of BO, which is to limit the extent of charges that can be created by an AI over its total assets on the other.

12. The Banking (Disclosure) (Amendment) Rules 2016 and the Banking (Specification of Class of Exempted Charges) (Amendment) Notice 2016 will come into operation on 31 March 2017 and 3 March 2017 respectively.

Concerns and views expressed by Members

13. Issues relating to the implementation of Basel III in Hong Kong were discussed at meetings of the Panel on Financial Affairs ("FA Panel") on 21 May 2012, 4 June 2012 and 7 July 2014; and those of the relevant subcommittees formed to study amendments to the Banking (Capital) Rules and the Banking (Disclosure) Rules in 2012 and 2013. The major views and concerns expressed by Members are summarized in the ensuing paragraphs.

Impacts of implementation of Basel III requirements

14. Members expressed concerns about the impacts of implementation of the Basel III requirements. Issues raised included the borrowing costs of the banking sector and the general business, whether AIs would become more prudent in lending which might cause difficulty for the small and medium enterprises and members of the public in obtaining credits, whether the implementation of Basel III requirements might result in over-regulation of the banking sector and additional costs on AIs, the difficulties AIs (particularly those small and medium-sized ones) might encounter in complying with Basel III standards, and whether the Hong Kong Monetary Authority ("HKMA") had assessed the impacts of implementation of Basel III requirements on local AIs

15. 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.

16. As regards the impact on AIs' cost and borrowing activities, HKMA explained that given that the capital adequacy ratio for AIs in Hong Kong had been maintained at a very high level in general (standing at 15.8% at the end of 2011 which well exceeded the statutory requirement of 8%), it was not envisaged that implementation of the new minimum capital adequacy ratios would increase the cost of borrowing for AIs. Nor would there be large-scale capital-raising activities for AIs to meet the new requirements. HKMA also pointed out that as AIs in Hong Kong had been well-capitalized, implementation of the new minimum capital adequacy ratios should not adversely affect AIs' lending to small and medium enterprises, and hence the borrowing cost for the general business, as well as members of the public. On the other hand, implementation of the Basel III requirements would further enhance the resilience of AI and enable them to continue lending during periods of economic downturn. Strong capital adequacy might also help reduce banks' cost for raising additional capital. HKMA further advised that a number of new requirements, such as those related to capital treatment for CCR and exposures to CCPs which would affect the transactions of OTC derivatives the majority of which were conducted by large AIs, would unlikely affect the operations of the small and medium-sized AIs.

17. Regarding the impacts of the second phase of Basel III requirements, the Administration advised that a number of relevant requirements, such as LCR requirements and the higher loss absorbency requirement, would only apply to larger AIs. A long transitional period would also be provided.

Given that the average capital adequacy ratio of AIs in Hong Kong stood over 15% and their strong liquidity position, the Administration did not envisage that AIs would encounter significant difficulties in implementing the second phase of Basel III requirements.

18. On the issue of impact assessment on the implementation of Basel III requirements, HKMA advised that a test run conducted by it for all locally-incorporated AIs revealed that all participant AIs were able to meet the first phase of Basel III capital requirements without difficulty. HKMA had also conducted quantitative impact studies on the implementation of the second phase of Basel III requirements, and concluded that the requirements concerned would unlikely bring significant problems to local AIs.

Dividend policies of the authorized institutions

19. Members noted that the second phase of Basel III implementation imposed a number of capital buffer requirements, and AIs would be subject to restrictions on their ability to make discretionary distributions when their capital levels were within the "buffer zone". They enquired whether AIs had to change their dividend policies to meet such requirements. HKMA advised that given the high capital levels enjoyed by local banks, it envisaged that it would not be common for their capital levels to fall within the "buffer zone" and thus be subject to the restrictions on making discretionary distributions.

Hong Kong's progress in the implementation of Basel III in comparison with other jurisdictions

20. Noting that some major jurisdictions like the European Union and the United States might experience some delay in the Basel III implementation timetable, Members were concerned that possible delay in other jurisdictions in implementing Basel III might cause competitive disadvantage to AIs in Hong Kong, and enquired whether HKMA would consider introducing flexibility in the implementation timetable of Hong Kong. They stressed the importance for Hong Kong to stay on par with other jurisdictions in implementing Basel III requirements to avoid exerting pressure on the operating costs of the Hong Kong banking sector.

21. The Administration responded that Hong Kong would follow the timeframe set by the Basel Committee in implementing Basel III requirements. It also pointed out that HKMA was statutorily required to consult the relevant banking and deposit-taking company associations in introducing the subsidiary legislation for implementation of Basel III standards. Given the benefits of

Basel III in bringing about a better capitalized and more resilient banking system for Hong Kong, the Basel Committee's determination to implement the first phase of Basel III standards on 1 January 2013, and the need for Hong Kong as a major international financial centre to align with the international implementation timetable, the Administration considered that Hong Kong should remain committed to implementing Basel III on 1 January 2013. As for the second phase of Basel III requirements, it was noted that most jurisdictions would adhere to the Basel Committee's relevant timetable. At Members' request, the Administration provided supplementary information on the respective progress of Hong Kong and G20 members in implementing the first and second phases of Basel III requirements.[12]

Latest Development

22. During the briefings on the work of HKMA at FA Panel meetings on 23 May and 15 November 2016, Members noted the plan of the Government to amend the Banking (Disclosure) Rules to implement the latest disclosure standards of the Basel Committee.

23. At the House Committee meeting on 6 January 2017, Members agreed to form a subcommittee to examine the Banking (Disclosure) (Amendment) Rules 2016 and the Banking (Specification of Class of Exempted charges) (Amendment) Notice 2016.

Relevant papers

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

Council Business Division 1
Legislative Council Secretariat
18 January 2017

[12] The information was set out in Annex D to the Legislative Council Brief on the Banking (Amendment) Ordinance 2012 (Commencement) Notice 2014, the Banking (Capital) (Amendment) Rules 2014 and the Banking (Liquidity) Rules.

Appendix

List of relevant papers

Date	Event	Papers/Minutes of meeting
29 February 2012	The Legislative Council ("LegCo") passed the Banking (Amendment) Bill 2011	Hansard Bill passed
21 May 2012	Briefing by the Hong Kong Monetary Authority ("HKMA") to the Panel on Financial Affairs ("FA Panel) 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	FA 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)
October 2012 – November 2012	LegCo formed a Subcommittee to scrutinize the Banking (Capital) (Amendment) Rules 2012, Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 and Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012	Legislative Council Brief (File Ref: G4/16/44C) Legal Service Division Report (LC Paper No. LS5/12-13) Report of the Subcommittee (LC Paper No. CB(1)230/12-13)

Date	Event	Papers/Minutes of meeting
April 2013 – May 2013	LegCo formed a Subcommittee to scrutinize the Banking (Capital) (Amendment) Rules 2013 and the Banking (Disclosure) (Amendment) Rules 2013 which were tabled in the Legislative Council	Legislative Council Brief (File Ref: G4/16/44C) Legal Service Division Report (LC Paper No. LS39/12-13) Report of the Subcommittee (LC Paper No. CB(1)1047/12-13)
7 July 2014	FA Panel was briefed on the proposed amendments to the Banking (Capital) Rules and Banking (Disclosure) Rules, and Enactment of the Banking (Liquidity) Rules, for implementation of Basel III standards in Hong Kong	Discussion paper (LC Paper No. CB(1)1668/13-14(03)) Background brief prepared by the Legislative Council Secretariat (LC Paper No. CB(1)1668/13-14(04)) Minutes of meeting (LC Paper No. CB(1)1998/13-14)
29 October 2014	The Banking (Amendment) Ordinance 2012 (Commencement) Notice 2014, the Banking (Capital) (Amendment) Rules 2014 and the Banking (Liquidity) Rules gazetted on 24 October 2014 were introduced into LegCo	Legislative Council Brief (File Ref: B&M/2/1/63C) Legal Service Division Reports 1 and 2 (LC Paper Nos. LS7/14-15 and LS15/14-15)
7 January 2015	The Banking (Disclosure) (Amendment) Rules 2014 gazetted on 24 December 2014 was introduced into LegCo	Legislative Council Brief (File Ref: B&M/2/1/63C) Legal Service Division Reports 1 and 2 (LC Paper Nos. LS25/14-15 and LS31/14-15)

Date	Event	Papers/Minutes of meeting
4 May 2014	Briefing by HKMA to FA Panel on its work	Power-point presentation materials by HKMA (LC Paper No. CB(1)780/14-15(02)) Minutes of meeting (LC Paper No. CB(1)1070/14-15)
28 October 2015	The Banking (Capital) (Amendment) Rules 2015 gazetted on 23 October 2015 was introduced into LegCo	Legislative Council Brief (File Ref: B&M/2/1/63C) Legal Service Division Report (LC Paper No. LS4/15-16)
23 May 2016	Briefing by HKMA to FA Panel on its work	Power-point presentation materials by HKMA (LC Paper No. CB(1)958/15-16(01)) Minutes of meeting (LC Paper No. CB(1)1142/15-16)
15 November 2016	Briefing by HKMA to FA Panel on its work	Power-point presentation materials by HKMA (LC Paper No. CB(1)141/16-17(01)) Minutes of meeting (LC Paper No. CB(1)364/16-17)
11 January 2017	The Banking (Disclosure) (Amendment) Rules 2016 and the Banking (Specification of Class of Exempted Charges) (Amendment) Notice 2016 gazetted on 6 January 2017 were introduced into LegCo	Legislative Council Brief (File Ref: B&M/2/1/63C) Legal Service Division Report (LC Paper No. LS22/16-17)