

For discussion
on 16 March 2017

Legislative Council Panel on Financial Affairs

Proposed Amendments to the Banking Ordinance

PURPOSE

This paper briefs Members on the Administration's plan to amend the Banking Ordinance in a bid to implement the latest international standards on banking regulation, by –

- (a) repealing certain provisions in relation to limits and restrictions on financial exposures incurred by Authorized Institutions¹ (“AIs”) and replacing them with a power for the Monetary Authority (“MA”) to prescribe financial exposure limits by way of making subsidiary legislation; and
- (b) empowering the MA to require AIs to maintain, make changes as deemed necessary to, and implement recovery plans.

BACKGROUND

Exposure Limits

2. Under the Banking Ordinance, AIs are subject to the prescribed limits on financial exposures which seek to prevent an AI's exposures from becoming overly concentrated in certain aspects. Part XV of the Banking Ordinance prescribes restrictions on advances made by AIs against the security of its own shares; limits on exposures of AIs to counterparties and their directors or employees; and other restrictions on shareholding, acquisition of share capital in companies and holding of interest in land etc. by AIs. The current exposure limits under the Banking Ordinance follow the international standards promulgated by the Basel Committee on Banking Supervision (“BCBS”) in 1991.

3. The BCBS, of which Hong Kong is a member, is the international body that sets standards on banking regulation with a view to enhancing financial stability. Following the BCBS' release in April 2014 of a new supervisory framework for measuring and controlling large exposures, it is incumbent upon Hong Kong to bring our regulatory regime up-to-date in accordance with the latest international standards.

¹ Authorized institutions refer to licensed banks, restricted licence banks, and deposit-taking companies authorized under the Banking Ordinance.

4. Compared with the 1991 standards, the new large exposures framework is more comprehensive in terms of coverage and provides more detailed guidance in relation to the calculation of exposures. For example, it prescribes the treatment of certain specific types of exposures, such as interbank exposures, exposures to sovereigns and their central banks, etc, so as to reduce the discrepancy of treatment among banks. It also provides a more stringent measurement of exposures by specifying that AIs should use its Tier 1 capital instead of total capital as the capital base for calculating the exposures.² By adopting the new large exposures framework, an AI could identify more effectively the maximum possible losses that it could incur if its counterparties fail. This in turn contributes to the stability of the financial system.

5. Implementing the new large exposures framework requires amendments to the Banking Ordinance to remove obsolete provisions and institute replacement rules. In view of the technical nature of the new large exposures framework, and considering that such rules need to be amended from time to time to reflect changes in international standards, it is proposed that the relevant provisions of the Banking Ordinance be repealed and replaced by a power for the MA to prescribe exposure limits by way of making subsidiary legislation. When the rule-making power is in place, the MA will separately introduce a piece of subsidiary legislation to implement the new large exposures framework. The existing provisions rendered obsolete by the new rules will be repealed at the same time when the subsidiary legislation commences operation.

6. The above approach of relegating the more technical rules to subsidiary legislation made by the MA is in line with that adopted for implementing the BCBS capital, disclosure and liquidity standards. The Banking Ordinance was amended in 2005 to empower the MA to make subsidiary legislation for the implementation of BCBS capital and disclosure standards vide the Banking (Capital) Rules and the Banking (Disclosure) Rules, and in 2012 for the implementation of liquidity standards vide the Banking (Liquidity) Rules. Since 2012, the Banking (Capital) Rules and the Banking (Disclosure) Rules have been separately amended four times to incorporate the complex and technical updates in the international standards. This reduces the need to amend the Banking Ordinance each time when there are changes in the international standards, thereby enabling the MA to implement such new standards locally in a more timely fashion.

Recovery Planning

7. The financial crises in recent years have pointed to the inadequacy of banks in preparing for severe stress events. To address this, the Financial

² Tier 1 capital is part of an AI's capital base, defined by the Banking (Capital) Rules (Cap. 155L).

Stability Board³ (“FSB”) issued in 2014 a revised set of standards relating to recovery planning and resolution planning⁴ in its “Key Attributes of Effective Resolution Regimes for Financial Institutions”. The Key Attributes require that recovery and resolution plans be put in place, at a minimum, for any financial institution that could be systemically important or critical if they fail. All member jurisdictions of the FSB, including Hong Kong, are expected to implement these standards to ensure that financial institutions are sufficiently prepared to respond to risk events.

8. The Financial Institutions (Resolution) Ordinance (“FIRO”) (Cap. 628), enacted in June 2016, was designed to meet the wider standards in the Key Attributes, including powers for resolution planning. In respect of recovery planning, the MA has to date relied on the information-gathering powers under the Banking Ordinance to require AIs to prepare recovery plans.

9. To provide greater transparency and certainty, it is considered necessary to prescribe explicit recovery planning requirements in the Banking Ordinance. Under these amendments, AIs will be required to maintain recovery plans, to make changes to those plans to address any deficiencies or impediments identified, and to implement the recovery plans. This will ensure compliance with the relevant FSB standards, which provide that relevant authorities should have the requisite powers to mandate the implementation of recovery measures.⁵

LEGISLATIVE PROPOSALS

Exposure Limits

10. In the light of the considerations set out in paragraphs 5 and 6 above, we propose that a new section be inserted into the Banking Ordinance to empower the MA to make rules prescribing limits and restrictions in respect of financial exposures incurred by AIs. Such rules will be in the form of subsidiary legislation, the making of which is subject to negative vetting by the

³ The FSB is an international body established by the G20 in 2009. It seeks to assess the vulnerabilities in the global financial system and propose actions to address them.

⁴ The basic difference between recovery planning and resolution planning is that the former is a going concern prudential requirement designed to avoid institution failure, whereas the latter is to ensure that institutions which are no longer a going concern can be allowed to fail in an orderly manner. Recovery plans should set out a full menu of recovery options, identify and explain how an AI will monitor the need to trigger the recovery options, and identify the key steps and milestones in implementing the recovery options.

⁵ The proposed approach of inserting a new Part to the Banking Ordinance in respect of recovery planning reflects the approach adopted in other jurisdictions, for example the European Union where the Bank Recovery and Resolution Directive contains specific provisions on recovery planning (Article 5 to Article 9) and early intervention measures, which require authorities to have powers to require banks in rapidly deteriorating financial conditions to implement one or more of the actions set out in the banks’ recovery plans (Article 27).

Legislative Council and statutory consultation on the same basis and with the same bodies⁶ as those applicable to the Banking (Capital) Rules, the Banking (Disclosure) Rules and the Banking (Liquidity) Rules.

11. The subsidiary legislation proposed to be made by the MA seeks to replace the relevant provisions in Part XV of the Banking Ordinance for the purpose of implementing the new BCBS large exposures framework. The existing provisions rendered obsolete as a result will be repealed on the commencement date of the subsidiary legislation. A list of the major provisions to be repealed and their replacement rules to be placed in the subsidiary legislation is at **Annex**.

Recovery Planning

12. We propose that a new part be inserted into the Banking Ordinance so that –

- (a) an AI must prepare, maintain and submit a recovery plan to the MA containing a range of recovery options which could be deployed by the AI's management to stabilise and restore the financial resources and the viability of the AI should it encounter circumstances of stress that might pose a significant threat to its financial soundness or viability;
- (b) an AI must notify the MA of the occurrence of any trigger event specified in its recovery plan or any deployment of a recovery action under the AI's recovery plan;
- (c) the MA may give directions to an AI in relation to its recovery plan (i) to ensure that the plan is fit for its purpose; (ii) to require changes to the recovery plan to address any deficiency or impediment identified by the MA; and (iii) as a last resort, to require an AI to implement its recovery plan when the MA considers that the AI is delaying the implementation, which is imperilling the viability of the AI and the MA considers implementation necessary to stabilise and restore the financial resources and viability of the AI; and
- (d) the MA may require a locally incorporated holding company of an AI to prepare and maintain a recovery plan.

Miscellaneous

13. The opportunity is also taken to repeal the Banking (Specification of

⁶ Including the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, the Hong Kong Association of Banks, the DTC Association and any other person as the MA thinks fit.

Public Sector Entity in Hong Kong) Notice (Cap. 155O), which is no longer required following the repeal of Schedule 4 to the Banking Ordinance in 2015.

CONSULTATION

14. The MA consulted the banking industry on its proposals for the implementation of the new BCBS exposure limits framework and recovery planning requirements in March and September 2016 respectively. The feedback received was generally supportive.

WAY FORWARD

15. We are in the process of drafting an amendment bill to implement the above legislative proposals, with a view to introducing the bill into the Legislative Council by the fourth quarter of 2017. This will allow time for the development of the necessary rules by the MA, and for the AIs to prepare for the implementation of the new BCBS large exposures framework in accordance with the internationally agreed timetable.

ADVICE SOUGHT

16. Members are invited to note and give views on the above proposals.

**Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
March 2017**

Major Provisions on Financial Exposure Limits to be Repealed and Replaced by Subsidiary Legislation

Section	Existing provisions	Major proposed revisions
80	An AI shall not grant certain types of credit facilities against its own shares or against the shares of its subsidiaries / sister companies / holding company.	<ul style="list-style-type: none">• The scope of the restricted security will be extended to include regulatory capital instruments in addition to shares.
81	The financial exposure of an AI incorporated in Hong Kong to a counterparty or a group of linked counterparties must not exceed an amount equivalent to 25% of the AI's total capital.	<ul style="list-style-type: none">• The calculation of exposure measures, including treatment of certain types of exposure that are currently exempted, will be specified.• Certain credit risk mitigation techniques applied to the exposure (e.g. exposure secured by a cash deposit) will then be recognised to reduce a relevant exposure for the purpose of determining compliance with the large exposure limits.• The limits in the form of a ratio will be rebased from a percentage of total capital to Tier 1 capital.
83	An AI incorporated in Hong Kong shall not provide any specified unsecured facilities to any specified person, such as directors of the AIs, to a certain percentage of the AI's capital base.	<ul style="list-style-type: none">• The scope of the limitation will be extended from specified unsecured facilities to the types of financial exposures in line with the new large exposures framework.

		<ul style="list-style-type: none"> The limits in the form of a ratio will be rebased from a percentage of total capital to Tier 1 capital.
87	An AI incorporated in Hong Kong shall not acquire or hold any part of the share capital of any other company to an aggregate value exceeding 25% of its capital base.	<ul style="list-style-type: none"> The scope of the restricted securities will be extended to include a wider range of equity exposures other than shares, for instance equity derivative contracts. The limits in the form of a ratio will be rebased from a percentage of total capital to Tier 1 capital.
87A	An AI incorporated in Hong Kong shall not acquire share capital of a company to a value of 5% or more of its capital base at the time of the acquisition.	<ul style="list-style-type: none"> The limits in the form of a ratio will be rebased from a percentage of total capital to Tier 1 capital.
88	An AI incorporated in Hong Kong shall not purchase or hold any interest in land of an aggregate value exceeding 25% of its capital base.	
90	The aggregate value of the holdings specified in sections 83, 87 and 88 of the BO shall not exceed 80% of the AI's capital base.	