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Paper for the House Committee meeting on 12 January 2018

**Report of the Bills Committee
on Banking (Amendment) Bill 2017**

Purpose

This paper reports on the deliberations of the Bills Committee on Banking (Amendment) Bill 2017 ("the Bills Committee").

Background

Recovery planning

2. The financial crises in recent years have pointed to the inadequacy of financial institutions ("FIs") in preparing for severe stress events. To address this, the Financial Stability Board ("FSB")¹ issued in 2014 a revised set of standards relating to recovery planning and resolution planning in its "Key Attributes of Effective Resolution Regimes for Financial Institutions" ("the Key Attributes"). The Key Attributes require jurisdictions to put in place an ongoing process for resolution and recovery planning covering, at a minimum, FIs that could be systemically important or critical if they fail. Supervisory authorities should ensure that FIs maintain a recovery plan that identifies options to restore financial strength and viability when they come under severe stress and the relevant authorities should also have the requisite powers to mandate the implementation of recovery measures. All member jurisdictions of FSB, including Hong Kong, are expected to implement these standards to ensure that FIs are sufficiently prepared to respond to risk events.

¹ FSB is an international body established by the G20 leaders in 2009. It seeks to assess the vulnerabilities in the global financial system and propose actions to address them.

3. The Financial Institutions (Resolution) Ordinance ("FIRO") (Cap. 628), enacted in June 2016 and came into effect in July 2017, was designed to meet the wider standards stipulated in the Key Attributes, including the requirements for resolution planning. In respect of recovery planning, the Monetary Authority ("MA") has to date relied on the information-gathering powers under the Banking Ordinance (Cap. 155) ("BO") to require authorized institutions ("AIs")² to prepare recovery plans. Currently, there are no explicit provisions under BO relating to recovery planning by FIs. To implement the FSB requirements, the Administration proposes to prescribe such explicit recovery planning requirements in BO.

Financial exposure limits

4. Under BO, AIs are subject to the prescribed limits and restrictions on financial exposures which seek to prevent an AI's exposures from becoming overly concentrated in certain aspects and hence risk-prone. Part XV of BO prescribes restrictions on advances made by AIs against the security of its own shares or against the shares of its subsidiaries and related companies; 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 BO follow the international standards promulgated by the Basel Committee on Banking Supervision ("BCBS")³ in 1991.

5. Following BCBS' release in April 2014 of a new supervisory framework for measuring and controlling large exposures, it is incumbent upon Hong Kong to bring its regulatory regime up-to-date in accordance with the latest international standards. 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. 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.

² AIs refer to licensed banks, restricted licence banks, and deposit-taking companies authorized under BO.

³ 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.

6. Implementing the new large exposures framework requires amendments to BO to remove obsolete provisions and institute replacement rules. In view of the technical nature of the new framework and the need to update the regulatory requirements from time to time to reflect the changes in international standards, the Administration proposes to confer a general power on MA to make rules prescribing limits on exposures incurred by AIs by way of subsidiary legislation.

The Bill

7. Against the above background, the Banking (Amendment) Bill 2017 ("the Bill") has been introduced into the Legislative Council ("LegCo") to amend BO to provide for recovery planning by AIs; to change the limitations on AIs' exposures; to empower MA to make rules for such limitations; and to repeal two items of subsidiary legislation made under BO (i.e. the Banking (Specification of Public Sector Entity in Hong Kong) Notice (Cap. 155O) and the Specification of Factors (Financial Exposure of Authorized Institution) Notice 2007 (Cap. 155P)).

Recovery planning

8. To implement the FSB requirement on recovery planning, a new Part XIII A (new sections 68A to 68I) is proposed to be added to BO to provide for recovery planning applicable to an AI incorporated in Hong Kong and an AI incorporated outside Hong Kong which operates in Hong Kong through a branch. MA would be empowered to require an AI to prepare, maintain and submit a recovery plan setting out the measures that the AI can take to stabilize and restore its financial resources and viability when the AI comes under severe stress (new section 68C).

9. MA would also be conferred with other powers in relation to recovery planning (see the new sections 68D to 68F and the new section 68H) including (a) imposing requirements on an AI if MA considers the imposition necessary or expedient to ensure that the AI's recovery plan is fit for the purpose; (b) requiring an AI to revise its recovery plan to address any deficiency or impediment identified by MA; (c) requiring an AI to implement one or more of the measures in its recovery plan if MA considers that the AI is delaying the implementation of the measure(s); and (d) requiring an AI to notify MA of the occurrence (or likely occurrence) of any trigger events specified in its recovery plan or the decision to implement a measure in its recovery plan (new section 68G). In addition, MA may impose similar requirements in relation to a recovery plan on an AI's holding company which is incorporated in Hong Kong.

10. If an AI (or its holding company) without reasonable excuse fails to comply with a requirement under sections 68C to 68H, the AI (or its holding company) would commit an offence and be liable (a) on conviction on indictment — to a fine at tier 9 (i.e. \$2,000,000) and in the case of a continuing offence, to a further daily fine at tier 5 (i.e. \$100,000); or (b) on summary conviction — to a fine at tier 5 (i.e. \$100,000) and, in the case of a continuing offence, to a further daily fine at tier 2 (i.e. \$10,000). Every director, chief executive and manager of the AI (or every officer in the case of the holding company of the AI) would also commit an offence and be liable to the above levels of fine and imprisonment for five years on conviction on indictment and imprisonment for two years on summary conviction (new section 68I).

Exposure limitation rules

11. For the purpose of implementing the new BCBS exposures framework, MA would be empowered, after consultation with the Financial Secretary, the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, The Hong Kong Association of Banks and The DTC Association, to make rules prescribing limits and restrictions in respect of exposures incurred by AIs (new section 81A). Such rules would be subsidiary legislation, the making of which is subject to negative vetting by LegCo. Certain sections under Part XV of BO in relation to restrictions on exposures incurred by an AI would become obsolete and be repealed upon commencement of the rules to be made by MA. MA would be empowered to require an AI to take remedial action if the AI fails to comply with any provision of the rules to be made under the new section 81A (new section 81B).

12. If an AI fails to comply with a notification requirement prescribed in the rules to be made or a remedial action requirement, it would commit an offence and be liable (a) on conviction on indictment — to a fine at tier 8 (i.e. \$1,000,000) and in the case of a continuing offence, to a further daily fine at tier 3 (i.e. \$20,000); or (b) on summary conviction — to a fine at tier 5 (i.e. \$100,000) and, in the case of a continuing offence, to a further daily fine at tier 2 (i.e. \$10,000). Every director, chief executive and manager of the AI would also commit an offence and be liable to the above levels of fine and imprisonment for five years on conviction on indictment and imprisonment for two years on summary conviction (new section 81C).

The Bills Committee

13. At the House Committee meeting on 27 October 2017, Members agreed to form a Bills Committee to scrutinize the Bill. The membership list of the Bills Committee is in **Appendix I**.

14. Under the chairmanship of Hon CHAN Chun-ying, the Bills Committee has held two meetings with the Administration and received views from deputations at one of the meetings. A list of organizations concerned which have given views to the Bills Committee is in **Appendix II**.

Deliberations of the Bills Committee

Views of deputations

15. All deputations are generally in support of the Bill. They agree that devising a recovery plan by AIs, changing the limitations of AIs' exposure and repealing obsolete provisions in BO will strengthen the ability of Hong Kong's banking system to cope with severe stress and are in accordance with the latest international standards on banking regulation issued by FSB and BCBS.

16. The deputations have indicated that most of the banks in Hong Kong have already prepared their own recovery plans to follow the standards relating to recovery planning issued by FSB in 2014. The deputations and the Administration consider that this has laid a sound foundation for implementing the proposed amendments in the Bill. The deputations have also indicated that they are not specifically concerned about the proposed level of penalties in relation to recovery planning. Instead, the focus of banks is on ensuring compliance.

17. Noting that the schedule for AIs to prepare for the implementation of the new BCBS large exposures framework in accordance with the legislative timetable (i.e. by 1 January 2019) is rather tight, the deputations have requested the Administration to allow sufficient time for them to make necessary arrangements before the relevant subsidiary legislation comes into effect. The Administration has responded that it will keep close communication with the banking industry, consult the industry with the proposed rules as soon as practicable and address their concerns as appropriate.

Consultation with the banking industry

18. Noting that MA has 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, and on the detailed provisions of the Bill in July 2017, the Bills Committee enquires about the technical comments which have been received from the industry.

19. In response, the Administration advises that the banking industry is generally supportive of the proposed amendments in the Bill. The industry has raised a number of technical comments in respect of the proposals for implementing the recovery planning requirements and the exposure limits framework.

20. On recovery planning, the industry has suggested that MA should take into consideration what have been developed by branches of overseas-incorporated AIs and locally incorporated AIs (that are part of the overseas banking group) in terms of its group recovery plan; and review the coverage of the term "revised plan". The industry has also sought clarifications from MA on the reliance on group recovery plans which local branches of foreign incorporated banks should be allowed to place; and the process for MA to issue a notice in writing for the imposition of requirements on an AI's recovery plans.

21. On exposure limits framework, the industry has suggested modernizing certain definitions and large exposure limits to keep pace with market developments, as well as ways to apply certain large exposures standards locally, such as to relieve smaller AIs from monitoring exposures on the basis of a group of linked counterparties. They have also sought clarification on certain technical terms and implementation details, such as the scope of aggregation of limits under the exposure limits regime.

22. The Administration has advised the Bills Committee that the industry's comments have been taken into consideration in the formulation of the Bill, and clarifications have been made as appropriate.

Penalties for committing an offence relating to recovery planning

23. The Bills Committee has asked how the penalties prescribed under the proposed new Part XIIA of BO for committing an offence relating to recovery planning compare with the penalties under legislation regulating other FIs in Hong Kong, such as the insurance companies and the approved

trustees of the Mandatory Provident Fund schemes; and vis-à-vis those in other overseas jurisdictions.

24. In response, the Administration has advised that the proposed new Part XIA seeks to introduce recovery planning requirements that are part of prudential regulatory requirements of the Hong Kong Monetary Authority ("HKMA"). In formulating the offence provisions under Part XIA, it has made reference to BO which contains similar prudential regulatory requirements, and FIRO, which establishes a cross-sectoral resolution regime for FIs across banking, insurance as well as the securities and futures sectors in line with the Key Attributes. The offence provisions under Part XIA are broadly in line with those under the two Ordinances.

25. The Administration is of the view that the proposed penalties for committing an offence under the new Part XIA are commensurate with the seriousness of the offence, taking into account that an AI's non-compliance with the requirements under Part XIA could materially affect the financial health of the AI concerned and have adverse impacts on the stability of the financial system in Hong Kong. It also highlights that the offence provisions specifically provide that an offence might only be committed if the non-compliance is "without reasonable excuse".

26. With respect to the offence provisions relating to recovery planning requirements in other comparable jurisdictions as gathered from publicly accessible information, the Administration has advised that while a range of approaches has been adopted by other jurisdictions, each approach reflects the local specificities in the jurisdictions. Similar to the case in Hong Kong, the penalty levels vary depending on the seriousness of the offence.

Communication with persons responsible for implementing the recovery plan

27. In view of the penalties for committing an offence relating to recovery planning, some members have enquired whether MA will consider issuing letters to directors of AIs (including independent non-executive directors) direct under certain circumstances to ensure that they have been notified of the important requirements or instructions issued by MA, such as the recovery planning requirements.

28. In response, the Administration notes that under the new Part XIA, MA should notify AIs of requirements or directions in relation to recovery planning by notice in writing. AIs and their senior management,

boards and directors (including independent non-executive directors) will be made aware of MA's recovery planning requirements through the AIs' established internal communication mechanisms. MA's guidance to AIs on recovery planning covers governance structure and oversight to ensure that the senior management and boards of directors are appropriately informed about AIs' recovery plan. In line with the FSB requirements, MA's guidance also specifies that responsibilities for the development, review, approval and the ongoing maintenance should be clearly assigned within AIs. These are in line with the FSB requirements, which state that AIs should have a robust governance structure which includes "clear responsibilities of business units, senior managers up to and including board members, and identifying a senior level executive responsible for ensuring the firm is and remains in compliance" with recovery plans.⁴

29. With respect to AIs' boards and their non-executive directors, MA's guidance also sets out the expected level of the AIs' boards' engagement on recovery planning. Specifically, an AI's board is expected to review and approve the AI's recovery plan at the time of its initial formulation, and thereafter at least on an annual basis. HKMA considers it essential that all members of the AI's board understand how the AI's recovery plan can be effectively deployed as a management tool to restore financial viability in a crisis. It is expected that a trigger event should always be brought to the attention of an AI's board, which should also be informed of the corresponding course of action determined by senior management and the relevant board committee. Moreover, it is the general practice of HKMA to maintain an ongoing dialogue with AIs on its prudential requirements, including the recovery planning requirements. This includes engaging in discussions with the board or senior management on AIs' regulatory requirements including recovery plan requirements as necessary. If appropriate, such engagement may also extend to AIs' directors.

Requirements/restrictions imposed on persons responsible for recovery planning

30. Some members have expressed concerns whether there are any requirements/restrictions imposed on directors or persons who are responsible for implementing the recovery plan, in particular in relation to the resignation of directors or other responsible officers, to protect the interests of the public and other stakeholders. They have also sought

⁴ Paragraph 1.18 of I-Annex 4 of the Key Attributes.

clarification as to whether the recovery plan mandates major shareholders of AIs to any commitments (e.g. prior agreement/undertaking on capital injection by shareholders) under severe stress.

31. In response, the Administration states that a recovery plan is a management tool "owned" by an AI and it follows that AI itself is best placed to assign appropriate personnel responsible for implementing the recovery plan, and impose any associated requirements/restrictions on the personnel as AI deems appropriate. Therefore, HKMA does not impose any specific requirement or restriction on directors or persons in the context of recovery planning.

32. More generally, however, HKMA has issued guidance on corporate governance of locally-incorporated AIs, which sets out the minimum standards HKMA expects locally-incorporated AIs to adopt in respect of their corporate governance as a whole. This includes the expectation on the boards of AIs to ensure that appropriate succession plans are in place for senior management, to actively engage in the succession plans for the chief executives and other key senior executives as appropriate, as well as to manage the associated risks in a range of possible scenarios.

33. The Administration further explains that whilst issuance of capital instruments (including shares) at short notice is generally deemed as one of the recovery options which AIs may consider, this does not envisage a "mandatory" or a "pre-committed" investment by major shareholders of AIs. Notwithstanding this, in a severe stress scenario, existing investors of AIs would have the greatest incentive to invest as they have a direct interest in the financial soundness and viability of AIs.

Impacts of recovery plans on the general public

34. Some members express concerns about the impact of recovery plans on the society and enquire whether the recovery plan of AIs will include measures which will adversely affect the general public, such as the call loan arrangements or reduction in the debts of AIs under severe stress.

35. The Administration has responded that it is not envisaged that the implementation of AIs' recovery plans will adversely affect the general public as it is a key objective of recovery planning that AIs can manage their operations on a business-as-usual basis. Moreover, recovery options are designed to restore AIs' viability, thereby avoiding the potential transmission of contagion to other AIs or to the wider financial system.

Consequently, the development of recovery plan will promote the stability and effective working of the banking system.

36. The Administration adds that since recovery plans are prepared and managed by AIs themselves, it is the responsibility of each AI to devise and propose what it considers to be the optimal approach for covering its operations and related entities in its recovery plan. Considering that recovery options need to be feasible, credible and material enough to substantially preserve or restore AIs' liquidity and capital level in a timely fashion, those involving retail customers are unlikely to be considered the most effective recovery options. As such, the Administration does not envisage that the execution of these measures by AIs would have impacts on the general public. In view of the effectiveness in restoring an AI's capital and liquidity level under severe stress, while deleveraging capital intensive asset classes can form part of an AI's recovery plan, this is likely to be achieved by not refinancing wholesale loans on maturity or exiting trading position overtime. The Administration also considers it highly unlikely that exercising call provisions in retail loan arrangements will be considered a recovery option that an AI will be able to utilize swiftly and effectively under severe stress to restore its capital or liquidity position.

Long title of the Bill

37. The Legal Adviser to the Bills Committee points out that a definition of "capital base" is proposed to be added to section 2(1) of the Banking (Capital) Rules (Cap. 155L) following the proposed repeal of the definition of "capital base" in section 2(1) of BO. It appears that such amendments are relating to and consequential upon the making of the exposure limitation rules. The Bill also contains other minor amendments, including providing for separate definitions of "subsidiary" (currently defined with "holding company" under section 2(1) of BO) and "holding company". According to the long title of the Bill, the Bill seeks to amend BO to provide for recovery planning by AIs; to change the limitations on AIs' exposures and empower MA to make rules for such limitations; and to repeal two items of subsidiary legislation made under BO. The Legal Adviser to the Bills Committee has sought clarification on whether the long title of the Bill can reflect such related, consequential and other minor amendments, as contained in the Bill, to BO.

38. In reply, the Administration confirms that as the substantive amendments and related, consequential and other minor amendments to BO contained in the Bill are to attain the main object of the Bill set out in paragraph 7 above, such amendments are covered by the long title.

Recovery planning of overseas-incorporated authorized institutions

39. The Legal Adviser to the Bills Committee has sought clarification on whether an overseas-incorporated AI with branch operations in Hong Kong can rely on its group recovery plan instead of preparing a local recovery plan and if not, whether it can do so if the branch has limited operations in Hong Kong.

40. In reply, the Administration explains that generally speaking, an overseas-incorporated AI (including an overseas-incorporated AI with limited operations in Hong Kong) may be permitted to rely on its group recovery plan to the extent that the group plan adequately covers its branch operations in Hong Kong. It would not be considered appropriate, for instance, if an overseas-incorporated AI solely relied on its group plan where it did not sufficiently address risks posed to its local operations or reflect the market specificities. Specific guidance has been developed and issued to the industry to facilitate the AI's recovery planning.

41. The Bills Committee enquires whether recovery planning will be required for AIs' holding companies which are incorporated overseas, and what actions will be taken in case an overseas-incorporated AI or its branch operations in Hong Kong is under severe stress.

42. The Administration has responded that the Key Attributes do not specify the extra-territorial reach with respect to the standard for extending powers in relation to recovery planning to AIs' holding companies which are incorporated overseas to avoid duplication of supervisory regimes. The approach proposed in the Bill is consistent with overseas jurisdictions, such as the European Union. The Administration and HKMA stress that in the event of an overseas-incorporated AI (or a locally incorporated AI which is part of an overseas banking group) being under severe stress, they will communicate with the relevant authorities supervising the AIs' holding companies for information and necessary coordination.

Remedial actions for exceeding an authorized institution's exposure limit

43. The Legal Adviser to the Bills Committee has enquired whether it is necessary to provide for a review mechanism under which an AI which is aggrieved by the decision of MA in relation to the requirement to take remedial action in a notice served under the new section 81B(2) can apply to the Banking Review Tribunal for a review of MA's decision under section 101B(1) of BO. She notes that a similar review mechanism is available to an AI which is aggrieved by the decision of MA requiring the

AI to take remedial action in relation to capital requirements under section 97E(3) and liquidity requirements under section 97J(3) of BO.

44. In response, the Administration explains that if an AI exceeds an exposure limit, it is envisaged that AI will be required to bring the relevant exposure below the limit within a specified period of time. MA will also see if the incident reveals any internal control weaknesses and, if so, the AI will be required to take actions to strengthen its internal controls. As such, it is expected that the remedial actions under the new section 81B(2) are more straightforward and the impact on AI is more limited than those under sections 97E(2) and 97J(2) of BO. The new section 81B(1) has already required MA to enter into discussions with the AI before imposing the remedial actions so that the AI's views can be taken into account among other relevant factors. The Administration envisages that there should be little room for review of the remedial actions required. In contrast, a review mechanism is provided for breaches of the capital and liquidity requirements because they could reflect more complex and serious problems and the required remedial actions would likely be more complex and might have more impact on the AI in question.

Offence for non-compliance with prescribed notification requirement or remedial action requirement under exposure limitation rules

45. Noting that contravention of prescribed notification requirement and remedial action requirement in relation to exposure limitation rules by an AI and its every director, chief executive and manager would be an offence under the new section 81C set out in paragraph 12 above, the Legal Adviser to the Bills Committee has sought clarification on whether a defence of reasonable excuse or a defence similar to the one under section 126(1) of BO (that in proceedings for an offence under BO it shall be a defence for the person charged to prove that he took reasonable precautions and exercised due diligence to avoid the commission of such offence by himself or any person under his control) should be provided for in the offence provision under the new section 81C. The Administration responds that a person (i.e. an AI, director, chief executive or manager) charged under the new section 81C may invoke the defence available under section 126(1) of BO. Thus, the Administration does not see the need to provide for the same defence again in the new section 81C and the approach is consistent with similar offence provisions in existing sections 97D and 97E (in relation to capital requirements) and sections 97I and 97J (in relation to liquidity requirements).

Committee Stage amendments

46. The Bills Committee and the Administration will not propose any Committee Stage amendments to the Bill.

Resumption of Second Reading debate on the Bill

47. The Bills Committee supports the resumption of the Second Reading debate on the Bill at the Council meeting of 24 January 2018.

Advice sought

48. Members are invited to note the Bills Committee's deliberations set out above.

Council Business Division 4
Legislative Council Secretariat
10 January 2018

Appendix I

Bills Committee on Banking (Amendment) Bill 2017

Membership list

Chairman	Hon CHAN Chun-ying
Members	Hon James TO Kun-sun Hon WONG Ting-kwong, GBS, JP Hon CHAN Kin-por, GBS, JP Hon YIU Si-wing, BBS Hon Charles Peter MOK, JP Hon CHAN Chi-chuen Hon Kenneth LEUNG Hon Dennis KWOK Wing-hang Hon Christopher CHEUNG Wah-fung, SBS, JP Hon Jimmy NG Wing-ka, JP (up to 21 November 2017) Hon YUNG Hoi-yan Hon Tanya CHAN Hon CHEUNG Kwok-kwan, JP Hon LAU Kwok-fan, MH (up to 29 November 2017)
	(Total : 13 members)
Clerk	Mr Lemuel WOO
Legal Adviser	Ms Vanessa CHENG

Bills Committee on Banking (Amendment) Bill 2017

**List of organizations that have submitted views
to the Bills Committee**

1. The Hongkong and Shanghai Banking Corporation Limited
2. Standard Chartered Bank (Hong Kong) Limited
3. The Hong Kong Association of Banks and Bank of China (Hong Kong) Limited
4. Chong Hing Bank Limited