



HONG KONG MONETARY AUTHORITY
香港金融管理局

DRAFT

**DISCLOSURE RULES
CONSULTATION PAPER**

APRIL 2006

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1. **INTRODUCTION**

- 1.1 Based on the Section 60A of the Banking Ordinance as amended by the Banking (Amendment) Ordinance 2005 which empowers the Hong Kong Monetary Authority (HKMA) to set rules prescribing the information to be disclosed to the general public by Authorized Institutions, the HKMA is inviting comments on all aspects of the proposed disclosure requirements set out as proposed Disclosure Rules in the Attachment.
- 1.2 Subject to specific provisions prescribed therein, the proposed Disclosure Rules will apply to both Authorized Institutions incorporated in Hong Kong and Authorized Institutions incorporated outside Hong Kong.
- 1.3 Any comments received from interested parties on the proposed Rules will be reviewed and carefully considered by the HKMA.
- 1.4 Please send written comments to:
- Basel II Team
Banking Policy Department
Hong Kong Monetary Authority
55th Floor
Two International Finance Centre
8 Finance Street
Central
Hong Kong
- Or by email to:
Basel2@hkma.gov.hk
- By [May 2006]
- 1.5 Additional copies of this Consultation Paper and the proposed Disclosure Rules are available for download from the HKMA's web site at <http://www.hkma.gov.hk>.

2. BACKGROUND

- 2.1 These Disclosure Rules (DRs) set out the minimum disclosure standards that the HKMA expects of Authorized Institutions (AIs) under the Banking Ordinance, covering both Hong Kong incorporated and overseas incorporated AIs. The DRs are intended to come into effect on 1 January 2007 to apply to all Disclosure Statements issued for the semi-annual/interim or annual reporting period beginning on or after 1 January 2007 (i.e. the first set of disclosure statements to which the DRs will be applied will be those relating to the position ending 30 June 2007. For disclosures made before that date, AIs should continue to follow the existing disclosure guidelines referred in section 2.5 below). The Rules also contain transitional provisions.
- 2.2 The DRs are being made pursuant to Section 60A of the Banking Ordinance (BO) as amended by the Banking (Amendment) Ordinance 2005 (BAO 2005) which empowers the HKMA to make DRs for the purpose of implementing the requirements of the new Capital Adequacy Framework (“Basel II”). In addition, the Rules also provide that where an AI fails to comply with any requirement applicable to it contained in rules made under this power, every director, every chief executive and every manager of the AI commits an offence that may lead to imposition of a financial penalty in accordance with the BAO 2005.
- 2.3 AIs subject to the disclosure requirements specified in the DRs (“Designated AIs”) are referred to as either “Designated Local AIs” (indicating those incorporated in Hong Kong) or “Designated Foreign AIs” (indicating those incorporated overseas) in the DRs. Part 2 of the DRs contains definitions of Designated AIs, including the threshold criteria that the HKMA will apply. AIs that meet the relevant thresholds are not required to comply with the DRs; however, the HKMA encourages them to adopt the disclosure standards set out in the DRs to the greatest extent possible. Where appropriate, the Monetary Authority may consider applying the requirements of these DRs to a controller of a Designated Local AI as assigned to it in section 2 of the BO.
- 2.4 The HKMA is under a general statutory responsibility to “promote the general stability and effective working of the banking system”. The Banking Ordinance currently provides, by Section 60, for the public disclosure of AIs’ audited annual accounts. It is also an authorization criterion in the Seventh Schedule of the Banking Ordinance that all AIs incorporated in Hong Kong (except for the smaller restricted licence banks and deposit-taking companies) make adequate disclosure of financial information in their audited annual accounts. While the Companies Ordinance provides the statutory framework for the issuance and external audit of annual accounts by Hong Kong incorporated companies, there is an explicit carve out for banks in the Tenth Schedule of the Companies Ordinance which relates to the preparation of financial accounts.

- 2.5 AIs are currently subject to the minimum disclosure requirements for annual and interim financial disclosures set out in the guidelines issued by the HKMA under the Banking Ordinance Section 16(10). These guidelines have been issued as modules of the HKMA's Supervisory Policy Manual, FD-1 ("Financial Disclosure by Locally Incorporated Authorized Institutions"), FD-2 ("Interim Financial Disclosure by Locally Incorporated Authorized Institutions") and FD-3 ("Financial Disclosure by Overseas Incorporated Authorized Institutions"). These will be collectively referred to as the "Financial Disclosure Guidelines."
- 2.6 The DRs will replace the Financial Disclosure Guidelines and will provide the basis on which the HKMA will henceforth expect AIs to make both annual and interim disclosures. Unlike the guidelines that they will replace the DRs will have the form of subsidiary legislation and therefore will have the same legal status as the Capital Rules. The HKMA's intention in drafting the DRs has been to align the disclosures required by the DRs as closely as possible with those in the Financial Disclosure Guidelines. Nonetheless, some changes have been inevitable.

3. REVISIONS TO EXISTING DISCLOSURE REQUIREMENTS

- 3.1 Three developments in particular have meant that revisions have needed to be made to the HKMA's existing disclosure requirements:
- (a) the impact of accounting changes, especially the enhanced disclosures under Hong Kong Financial Reporting Standard 7 (HKFRS 7)¹ and Amendment to Hong Kong Accounting Standard 1 (HKAS 1)²;
 - (b) additional information suggested by users of Financial and Disclosure Statements during the preliminary consultation process in order to keep Hong Kong AIs' disclosure in line with best practices elsewhere; and
 - (c) enhanced disclosures needed to bring Hong Kong requirements broadly into line with the recommendations contained in Pillar 3 of Basel II.
- 3.2 A major development since the Financial Disclosure Guidelines were last revised has been the enhancement of disclosures required under Hong Kong accounting standards, in particular HKFRS 7 *Financial Instruments: Disclosures*. Accordingly, the HKMA has used the opportunity presented in drafting the DRs to align its disclosure requirements for AIs with these general accounting disclosures. It should be emphasised, however, that it is not the HKMA's intention to require AIs to make duplicative disclosures. To the extent that the disclosure requirements of the DRs map to those required by the

¹ HKFRS 7 *Financial Instruments: Disclosures*

² Amendment to HKAS 1 *Capital Disclosures*

accounting standards, the HKMA will consider that its requirements have been met by AIs' disclosures made under the relevant accounting standards. In addition to the statutory responsibility of the HKMA on ensuring adequacy of disclosures by AIs highlighted in 2.4 above, the HKMA's aim in incorporating the accounting disclosures into its DRs is primarily to be able to provide an additional level of detail and guidance on the form that these disclosures should take in the specific case of AIs. In this connection, the HKMA has prepared a Guideline on Operation of the Disclosure Rules (enclosed at Annex to the Draft DRs) to facilitate ease of interpretation for all Designated AIs of the DRs.

3.3 In preparing the current draft of the DRs, the HKMA has also held a number of discussions with various users of Financial and Disclosure Statements (e.g. rating agencies and equity analysts) to ensure that its disclosure requirements continue to meet their needs. These discussions have indicated that there is a strong demand on the part of analysts for greater information on the extent of AIs' mainland exposures. This reflects market developments since the HKMA first issued its Best Practice Guide on Financial Disclosures by Authorised Institutions in 1994. Accordingly, the HKMA has accommodated this demand by enhancing disclosures about AIs' mainland exposures as part of the supplementary information disclosures under the DRs.

3.4 These draft DRs have also been revised to take into account comments from both Members of the Working Party on Financial Disclosure and the Basel II Consultation Group as well as Members of the Technical Working Group on Financial Disclosure during preliminary consultation. In the light of the general concern raised by some AIs and members of the accounting profession with respect to the relationship between the DRs and potential future changes to the relevant accounting standards, the HKMA's presumption in this context will be that the DRs should continue to reflect the relevant accounting requirements. The HKMA will only adopt DRs that are at variance with the relevant accounting standards when there is some overriding reason for it to do so, based on the HKMA's statutory objectives. To ensure that the DRs continue to remain aligned with the relevant accounting standards the HKMA has undertaken to conduct regular reviews of its disclosure requirements for AIs in collaboration with the Hong Kong Institute of Certified Public Accountants (HKICPA).

4. PILLAR 3 DISCLOSURES UNDER BASEL II

4.1 The third, and most important, factor influencing the disclosures required under the DRs has been the recommendations contained in Pillar 3 of Basel II. The three pillars of Basel II are intended to be mutually reinforcing, and thus Pillar 3 complements the minimum capital requirements contained in Pillar 1 and the supervisory review process in Pillar 2. The disclosures required under Pillar 3 aim to supplement supervision through enhanced transparency and market discipline. Accordingly, Pillar 3 sets out disclosure requirements that

are intended to allow market participants to obtain key pieces of information on the capital, risk exposures, risk assessment processes, and hence the capital adequacy of banks.

- 4.2 In line with the Pillar 3 recommendations, the HKMA intends to introduce a larger risk-based element into AI's financial disclosures than hitherto. The guiding principle adopted by the HKMA's revisions to its disclosure regime has been that different disclosure requirements should apply to different capital adequacy approaches. AIs which adopt the Basic Approach to the calculation of credit risk will be subject to disclosure requirements that are fundamentally little changed from the current Financial Disclosure Guidelines, with the exception of additional disclosures required in respect of operational and market risks. By contrast, additional disclosures will be required of AIs adopting the more sophisticated approaches, with the most intensive disclosures being required of AIs using the Internal-ratings Based (IRB) approaches.
- 4.3 The HKMA believes that it is appropriate for the disclosures made by AIs adopting the Standardised and IRB approaches to reflect the full range of risks to which these institutions are potentially exposed. Thus the additional disclosures that will be required of them will include qualitative and quantitative elements of credit risk, market risk, operational risk and interest rate risk. In reaching this conclusion the HKMA has carefully balanced the additional costs involved in such disclosures with the benefits in terms of enhanced market discipline that it believes will result.
- 4.4 AIs adopting the Standardised Approach will be required to make more extensive disclosures than Basic Approach institutions, particularly relating to derivatives and counterparty credit risk, credit risk mitigation, asset securitisation, market risk, operational risk and interest rate risk in the banking book. These enhanced disclosures reflect both the relatively more sophisticated nature of these institutions' business, and the broader range of risks captured by the Standardized Approach compared to its predecessor.
- 4.5 The most extensive disclosures will be required of AIs adopting the IRB approaches, given the sophistication of these AIs' business operations and the comparatively broad range of risks that they incur. Although the disclosure requirements for IRB banks are broadly similar to those banks adopting the Standardized Approach, the key difference between them is the greater level of detail required in the disclosures made by IRB banks. In particular, IRB banks will be required to make sufficient additional disclosures, both qualitative and quantitative, to enable market participants to form a considered view of the robustness and effectiveness of their internal risk rating systems. They will also be required to make additional disclosures in terms of risk exposures by risk bucket, as well as their methodology in calculating loan loss estimates and provisions. The HKMA believes that a relatively high

degree of disclosures by IRB banks is in keeping with the spirit of Basel II.

- 4.6 The HKMA recognises that several AIs that will adopt the IRB approach are subsidiaries of overseas parents. Accordingly, it is possible that the parent bank may make disclosures – particularly qualitative disclosures concerning internal ratings systems – that are intended to apply on a group-wide basis. Where this is the case, the AIs are required to satisfy the HKMA that the disclosures made by the overseas parent have met the disclosure requirements in these DRs. In addition, group-level disclosures must provide sufficient detail that it is possible for third parties clearly to identify the range of risks being incurred by the Hong Kong operations of these banking groups, and to understand how those risks are managed.
- 4.7 As far as overseas incorporated AIs are concerned, with the exception of additional disclosures relating to mainland exposures as already described in paragraph 3.3 above, there will be little change to the substance of the required disclosures. However, the proposal to include the disclosure requirement for overseas incorporated AIs into the DRs has the effect of making these requirements a statutory requirement under the revised disclosure framework.

5. IMPLEMENTATION APPROACH

- 5.1 **No audit** of disclosures made under the DRs is required unless otherwise required by accounting or other statutory requirements. The HKMA has endeavoured to ensure that the definitions used in these DRs are consistent with the definitions used in the relevant accounting standards, on the one hand, and the Capital Rules on the other. The HKMA's intention is that any terms and definitions not specifically defined in the DRs will have the same meaning and interpretation as that applied under the Capital Rules. The HKMA will also provide additional guidance and clarification in the corresponding guidelines to the DRs.
- 5.2 Pillar 3 disclosures applicable to Designated Local AIs are only required on an **annual basis** instead of more frequent disclosure recommended by the Basel Committee. This variation represents the pragmatic approach adopted by the HKMA in implementing Basel II in Hong Kong and help ensuring that the HKMA's disclosure requirements are in line with those required by other leading regulators such as the Financial Services Authority in the United Kingdom.
- 5.3 Subject to a few exceptions specified in Part 2 of the Attachment, the DRs will apply at the top consolidation group level of a Designated Local AI on the basis of consolidation for capital adequacy purposes.

- 5.4 All Designated AIs are required to publish a Disclosure Statement containing the disclosures required under these DRs. The Disclosure Statement can be published either as a stand-alone document or, for Designated Local AIs that are listed in Hong Kong, as an Annex to the AI's Annual and interim report. AIs may publish all the required information in the Disclosure Statement or provide a summary of the disclosures with complete information being made available on the AI's publicly accessible internet web site (including the disclosures made by overseas parents on which an AI relies in fulfilling the disclosure requirements in these DRs). In the latter case, AIs should ensure the information included in the summary of the Disclosure Statement is presented in a sufficient reliable manner and not misleading in any material aspect for the public understanding of the AI's position. AIs should also include a statement in the summary of the Disclosure Statement concerning the location where all the required information can be found. An example of the specimen disclosure templates is included in the Guideline on Operation of the Disclosure Rules for AIs' reference.
- 5.5 For AIs that are not required to comply with the disclosure requirements set out in the DRs, the HKMA encourages them to comply with the disclosure requirements to the greatest extent possible. Copies of any disclosure documents that they prepare should be lodged with the HKMA, so that they can be included in its public registry maintained under Section 20 of the BO.
- 5.6 As the DRs will be made under Section 60A of the BO as amended by the BAO 2005 there will be clear checks and balances on the HKMA's exercise of its rule-making power. The HKMA will be obliged to issue a draft of the proposed DRs to, and invite comments from, the Hong Kong Association of Banks, the DTC Association, the Banking Advisory Committee and the Deposit-taking Companies Advisory Committee. The HKMA will also need to consult the Financial Secretary before issuing the DRs, and may consult other interested parties (such as the Hong Kong Institute of Certified Public Accountants) as the HKMA considers appropriate. The DRs will have the status of subsidiary legislation and hence will be subject to negative vetting by the Legislative Council.
- 5.7 The HKMA will continue to keep its disclosure requirements under review, and will take into account subsequent future developments, including the implementation approaches being taken by other regulators overseas and international accounting changes. The content of the DRs will also be kept under regular review by the HKMA with the HKICPA as appropriate, and necessary amendments and additions may be issued by the HKMA to keep the regime up-to-date in light of industry, accounting developments and evolving international practice.

6. STRUCTURE OF THIS CONSULTATION DOCUMENT

6.1 Provision

6.1.1 The draft Rules contained in the Attachment to this consultation paper may be cited as the draft DRs.

6.1.2 The DRs should be read in conjunction with other HKMA guidance papers regarding Basel II implementation, in particular those related to the Capital Rules.

6.2 Structure and Format of the Disclosure Rules

6.2.1 The DRs are presented in a menu-approach format designed to facilitate AIs to apply with respect to the specific credit risk approach(es) applicable to the AI's own circumstances. For ease of application, the DRs are divided into eight parts as follows:

Part 1 - Preliminary

Part 2 - General Requirements

Part 3 - Annual and Interim Financial Disclosures Applicable to Designated Local AIs

Part 4 - Additional Annual Disclosures Specific to Designated Local AIs Using the Basic Approach to Calculation of Credit Risk

Part 5 - Additional Annual Disclosures Specific to Designated Local AIs Using the Standardized Approach to Calculation of Credit Risk

Part 6 - Additional Annual Disclosures Specific to Designated Local AIs Using the Foundation or Advanced Internal-Ratings Based Approach to Calculation of Credit Risk

Part 7 - Half Yearly Disclosures by Designated Foreign AIs

Part 8 - Implementation and Transitional Provisions