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For discussion
on 4 June 2012

Legislative Council Panel on Financial Affairs

Progress in Implementation of Basel III Standards in Hong Kong

PURPOSE

The Legislative Council enacted the Banking (Amendment) Ordinance 2012 on 29 February 2012, to provide for the legal framework for implementation, in Hong Kong, of the revised regulatory capital and liquidity standards promulgated by the Basel Committee on Banking Supervision ("BCBS") (known as "Basel III"). New sections 97C and 97H of the Banking Ordinance ("BO", Cap. 155) empower the Monetary Authority ("MA")[1] to make rules to prescribe capital and liquidity requirements applicable to authorized institutions ("AIs")[2]. In this connection, this paper seeks to update Members on –

(a) the progress in respect of implementation of the relevant Basel III regulatory capital standards (and the corresponding disclosure requirements), which are scheduled to take effect from 1 January 2013 under the BCBS's transitional timeline for Basel III; and

(b) the legislative timetable for the proposed subsidiary legislation required to implement the first phase of Basel III with effect from 1 January 2013.

BASEL III

2. Building upon an earlier package dubbed "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 was

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[1] In this paper, MA refers to "Monetary Authority" or "Hong Kong Monetary Authority", as the context so requires.

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

endorsed by the G20 Leaders in November 2010, and they are committed to implementing Basel III fully in line with the BCBS transitional timeline[3]. This means that implementation should begin in January 2013, with the standards being phased-in over the subsequent six years to achieve full implementation by 1 January 2019.

3. As a major international financial centre and a member of the BCBS [4], Hong Kong needs to follow the timeline agreed internationally, in order to ensure that the capital and liquidity frameworks for AIs in Hong Kong are consistent with international standards, and that our AIs will not be disadvantaged vis-à-vis their peers outside of Hong Kong.

MAJOR ELEMENTS OF THE FIRST PHASE OF IMPLEMENTATION OF BASEL III IN HONG KONG

4. 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.

5. MA proposes to amend the Banking (Capital) Rules (Cap. 155L) and Banking (Disclosure) Rules (Cap. 155M) within this year, in order to implement the **first phase** of Basel III requirements scheduled to take effect in January 2013, as described broadly in the ensuing paragraphs[5].

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[3] The transitional implementation timeline promulgated by the BCBS is at **Annex A**.

[4] The BCBS is committed to monitoring the global implementation of the Basel III standards through a vigorous assessment process. Status reports on the compliance of BCBS member jurisdictions will be issued to the G20 and published on the BCBS's website.

[5] The first phase of Basel III implementation focuses on the introduction of a strengthened capital framework, notably, the three minimum risk-weighted capital ratios (as elaborated in paragraph 6 of this paper), which will take effect starting from 1 January 2013, with the levels of the ratios progressively increasing until 2015. The new capital buffers, the leverage ratio, and the liquidity standards will be phased-in gradually thereafter.

6. *First*, Basel III reduces the "tiers" of banks' regulatory capital from potentially three tiers to two[6], and **increases the minimum regulatory capital requirements** (expressed as a percentage of banks' risk-weighted assets). In this regard -

(a) **Tier 1 Capital** is set at a **minimum 6%**, comprising **Common Equity Tier 1** ("CET1", principally ordinary shares and retained earnings) of at least 4.5% of risk-weighted assets, and **Additional Tier 1** ("AT1", covering non-cumulative preference shares and perpetual subordinated debt instruments);

(b) **Tier 2 Capital** is supplementary capital covering cumulative preference shares and dated subordinated debt instruments; and

(c) **Total Capital** (combining both Tiers 1 and 2) must be **at least 8%**, which is the same as the current requirement prescribed under the BO.

7. *Secondly*, Basel III **tightens the criteria for instruments to qualify for inclusion in the capital base** to ensure that capital instruments are genuinely loss-absorbing[7]. In particular, both AT1 and Tier 2 capital instruments are required to be capable of being converted into ordinary shares or written off at a point when the relevant regulatory authority determines the issuing banks to be non-viable. To this end, MA intends to amend Part 3 of the Banking (Capital) Rules to reflect these enhanced criteria.

8. *Thirdly*, Basel III **restricts recognition of minority interest** (i.e. capital issued by banks' consolidated subsidiaries and held by third parties) **in banks' consolidated capital base**. An amount in respect of minority interest arising from capital instruments issued by any subsidiary of a parent bank will be recognised in the corresponding capital tier of the parent bank only if (a) the subsidiary is itself a bank or

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[6] A diagram showing the differences between Basel II and Basel III, in terms of the definition and categories of capital, is shown in **Annex B**. In Hong Kong, Tier 3 capital is not currently made available as a constituent of banks' capital base. There will remain two tiers of capital for locally incorporated AIs after the introduction of Basel III.

[7] The criteria for classification of CET1, AT1 and Tier 2 Capital are detailed in **Annex C**.

an institution that is subject to the same minimum prudential standards and level of supervision as a bank, and (b) the capital instruments meet the Basel III qualifying criteria. In addition, any recognised minority interest must not include any "surplus capital"[8] attributed to minority shareholders, as it may not be ultimately available to support the risk of the whole bank group.

9. *Fourthly*, Basel III **harmonises the deductions and exclusions for calculating the regulatory capital base**, **and requires these to be applied mostly to CET1**. Deductions can be broadly classified into two categories –

(a) Items that ultimately may not provide a bank with loss absorbent capital to the extent of their accounting value, including: (i) goodwill and other intangibles; (ii) deferred tax assets; (iii) shortfalls in the stock of provisions relative to expected losses; (iv) gains on sale related to securitisation transactions; and (v) defined benefit pension fund assets[9]; and

(b) Items that inflate regulatory capital within the financial system by virtue of their double-gearing effect, including: (i) investments in own capital instruments; (ii) reciprocal cross-holdings in the capital of financial institutions; and (iii) investment in the capital of financial institutions outside the scope of regulatory capital consolidation[10].

10. *Fifthly*, Basel III contains **enhanced disclosure requirements** corresponding to the revisions to the definition of capital, in order to improve transparency of regulatory capital, improve market discipline, and enhance consistency and comparability of capital positions among banks across jurisdictions. In this regard, AIs will be required to

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[8] "Surplus capital", for this purpose, is capital exceeding the minimum that the subsidiary has to maintain to meet both the minimum capital ratios and the capital conservation buffer applicable to it.

[9] Under the current Banking (Capital) Rules, (i), (ii) and (iv) are deducted from Core Capital, and item (iii) is deducted 50% from Core and 50% from Supplementary Capital. Item (v) is not covered.

[10] Under the current Banking (Capital) Rules, there are similar deductions which are made 50% from Core and 50% from Supplementary Capital, but the classification and coverage for item (iii) is different, insofar as the current framework focuses on the relation between an AI and the entity in which the investment occurs, whereas Basel III focuses on whether that entity is a financial institution or otherwise.

disclose, among others, a detailed breakdown of regulatory capital constituents as well as a full reconciliation of all regulatory capital elements back to the AIs' financial statements to account for the differences in the scope of consolidation for accounting and for regulatory purposes[11]. MA intends to amend the Banking (Disclosure) Rules to implement the relevant disclosure requirements.

11. *Sixthly*, Basel III **enhances the risk coverage of the capital framework** (i.e. the risk-weighted asset measure in the regulatory capital ratios), by introducing measures to strengthen the capital requirements for counterparty credit risk ("CCR") exposures[12]. MA proposes to reflect the enhancements which Basel III incorporates in the counterparty credit risk framework. Key elements include (i) the use of stressed inputs into the capital calculation process; (ii) a new capital charge for potential loss when the value of a contract falls, on mark-to-market valuation; (iii) strengthened collateral management standards; (iv) lower risk weights for certain exposures to central counterparties; (v) higher risk weights for exposures to large financial institutions; and (vi) stricter treatment for transactions with "wrong-way risk" (i.e. cases in which the exposure increases when the credit quality of the counterparty deteriorates).

INTERNATIONAL PRACTICE

12. We set out at **Annex D** some information on the progress of other comparable jurisdictions in the implementation of Basel III. All of them (for instance, Australia, Singapore, Japan, Mainland China, New Zealand and the European Union) appear to be making substantial progress towards commencing implementation of Basel III from January 2013. Some have elected to implement in advance of the BCBS transitional timeline in certain aspects, and some have opted for a certain degree of "gold-plating" of the Basel III standards (i.e. increasing levels compared to Basel minimum requirements) to address their own prudential concerns[13].

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[11] Other disclosure requirements will likely include a description of all limits and minima, and the main features of capital instruments issued. AIs may also need to accompany disclosures of non-regulatory ratios with a comprehensive explanation of their calculation, and to make available on their websites the full terms and conditions of all instruments included in regulatory capital.

[12] CCR exposures means the risk of loss when a counterparty to a derivatives, repo or securities financing transaction defaults before the cash flows for the transaction are finally settled.

MARKET ENGAGEMENT AND CONSULTATION

13. It is important that the banking industry in Hong Kong is fully engaged in, and prepared for, Basel III implementation. To this end, MA is committed to an ongoing consultation process in order to roll out, in phases, policy and technical proposals in respect of the enhanced capital, liquidity and disclosure requirements. Generally, proposals are discussed at the regular meetings of the Banking Advisory Committee and Deposit-taking Companies Advisory Committee before detailed consultation papers are issued to The Hong Kong Association of Banks and The DTC Association for comment.

14. To this end, MA kick-started the first phase of industry consultation in January 2012, covering broadly the new definition of capital, minimum capital requirements, and enhancements to the CCR framework, as well as the preliminary thinking on the scope of application of the liquidity standards (see paragraphs 5-11 above for the capital-related requirements). The banking industry noted general support for the enhancement of the regulatory capital regime and the alignment with the Basel III standards. It is also supportive of MA's proposal to adopt the BCBS' transitional timeline for implementation.

15. Basel III is a minimum standard and the BCBS recognises that for prudential reasons local regulators / supervisors may modify or adapt requirements to address local circumstances. In this connection, during the industry consultation, MA raised the prospect of making some modifications to the Basel III requirements for prudential reasons having regard to local circumstances. Some of these modifications are in line with, and reflect, the current position prescribed under the Banking (Capital) Rules. These technical issues are described in **Annex E**.

16. In its submission in response to the consultation, the banking industry, however, has stressed the importance of implementing Basel III on a comparable basis to create and maintain a level playing field. It

[13] It should however be borne in mind that a straight read-across comparison among jurisdictions may potentially be misleading if jurisdictions' implementation approaches are not viewed holistically. Differences in the calculation of the components of the minimum ratios may make ostensibly comparable levels of minimum capital more or less stringent in reality. Some jurisdictions may make trade-offs between "gold-plating" a minimum ratio and employing less stringent calculation mechanics. Further, jurisdictions' use of the supervisory review process under Pillar 2 of the Basel capital framework to increase minimum capital requirements by a "Pillar 2 capital add-on" may vary significantly between jurisdictions.

noted that, for areas where varied or modified standards are proposed for Hong Kong, the reasons should be carefully articulated and the consequences understood. MA is currently considering the extent to which it can prudently address the industry's submissions, and has indicated to the industry a number of respects in which their suggestions can be addressed. Discussions with the industry are still underway. The constructive views of the industry have helped refine the proposals for Basel III implementation in Hong Kong. MA will continue to roll out for consultation further proposals on other areas of Basel III (including disclosure and liquidity requirements), and pursue an active and constructive dialogue with the industry.

IMPACT ASSESSMENT ON BANKS IN HONG KONG

17. MA is monitoring the capital positions of local banks and their process of planning for the implementation of Basel III. **They are generally well-capitalised (the average capital adequacy ratio was 15.8% and the average Tier 1 ratio was 12.4%, at the end of 2011).** They have traditionally placed significant reliance on common equity to meet regulatory capital requirements (with common equity accounting for around 88% of Tier 1 capital overall). Furthermore, many of the Basel III regulatory deductions are already required to be deducted from Tier 1 capital under the existing Banking (Capital) Rules. In MA's assessment, local banks should be relatively well-placed to meet the higher capital requirements, particularly given the accommodating BCBS transitional timeline, although some banks indicated that they will adopt a prudent approach in strengthening and consolidating their capital resources, and in managing their capital positions, in anticipation of the introduction of the enhanced regulatory capital standards.

LEGISLATIVE TIMETABLE

18. In order to embark on the first-phase of implementation of Basel III with effect from 1 January 2013[14], we are working swiftly to formulate the subsidiary legislation prescribing the detailed rules, which are inevitably highly complex and technical.

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[14] The Basel III implementation process will continue after 1 January 2013 in respect of those standards within Basel III which come into effect from 2014 through 2019, particularly in relation to capital buffers, leverage ratio, and liquidity ratios. We will brief the Panel on the progress from time to time.

19. To this end, MA intends to table before LegCo the **Banking (Capital) (Amendment) Rules 2012** and **Banking (Disclosure) (Amendment) Rules 2012** for negative vetting in Q4/2012. Prior to this MA will undertake a formal statutory consultation on the draft rules in Q3/2012 with the Financial Secretary, the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, The Hong Kong Association of Banks, and The DTC Association, in accordance with sections 97C and 60A of the BO. The target is for the amendment rules to come into operation on 1 January 2013. [15]

20. MA will also take the opportunity to introduce a technical amendment to the Banking (Specification of Multilateral Development Bank) Notice (Cap. 155N) to implement a decision of the BCBS to include the Multilateral Investment Guarantee Agency ("MIGA"), which is a member of the World Bank Group, in the list of multilateral development banks for the purposes of the Basel capital framework. The effect of this inclusion is that banks' exposures to MIGA will be afforded the same preferential treatment for capital calculation purposes as is currently available to exposures to other recognised multilateral development banks, under the BO and the Banking (Capital) Rules. The background of the **Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012**, which is to be made by MA under section 2(19) of the BO in Q4/2012, is set out at **<u>Annex F</u>**.

21. Members are invited to note the progress of Basel III implementation in Hong Kong and the Administration's legislative plan as set out in this paper.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
May 2012

[15] To do so, the rules will have to be tabled at LegCo by late October 2012 for negative vetting.

Annex A

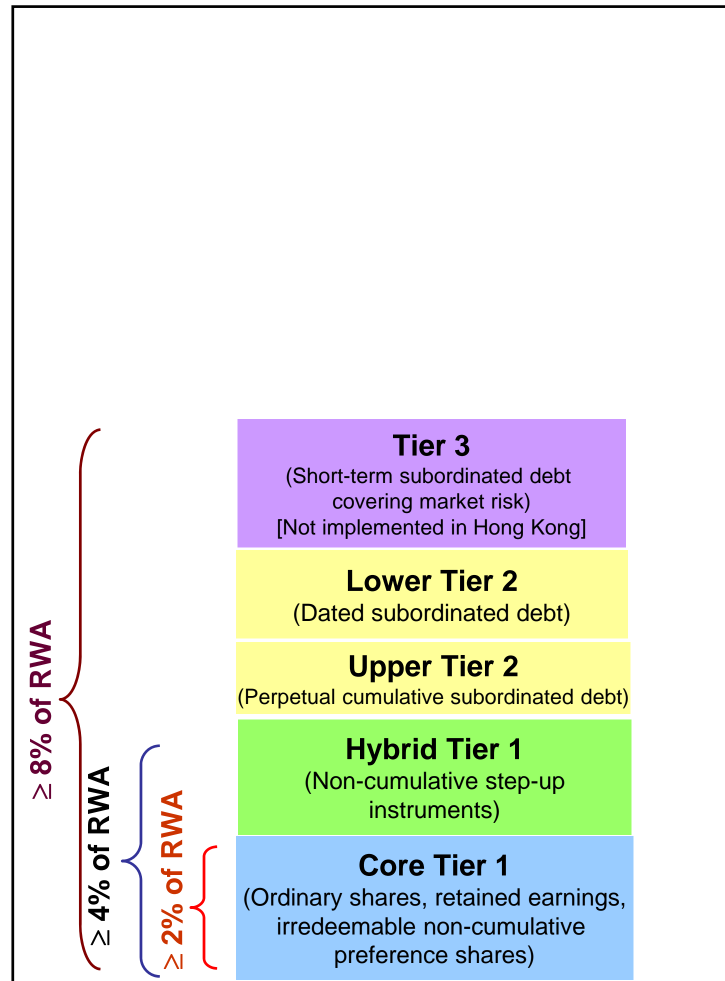
Basel III
Transitional Implementation Timetable

	2011	2012	2013	2014	2015	2016	2017	2018	2019
			Basel III Capital Standards						
Min CET1 capital ratio			**3.5%**	**4.0%**	**4.5%**	**4.5%**	**4.5%**	**4.5%**	**4.5%**
Capital conservation buffer (CSB)						**0.625%**	**1.25%**	**1.875%**	**2.5%**
Maximum countercyclical capital buffer [if imposed]						***[0.625%]***	***[1.25%]***	***[1.875%]***	***[2.5%]***
Min CET1 + CSB			**3.5%**	**4.0%**	**4.5%**	**5.125%**	**5.75%**	**6.375%**	**7.0%**
Min Tier 1 capital ratio			**4.5%**	**5.5%**	**6.0%**	**6.0%**	**6.0%**	**6.0%**	**6.0%**
Min Total Capital ratio	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**
Min Total Capital + CSB			**8.0%**	**8.0%**	**8.0%**	**8.625%**	**9.25%**	**9.875%**	**10.5%**
Capital instruments that no longer qualify as non-CET1 capital or Tier 2 capital			**Phased out over 10 year period starting 1.1.2013**						
Regulatory adjustments from CET1 (same for AT1 and Tier 2) required under Basel III			**0%**	**20%**	**40%**	**60%**	**80%**	**100%**	**100%**
Minority interests not recognized under Basel III but recognized under current framework			**100%**	**80%**	**60%**	**40%**	**20%**	**0%**	**0%**
			Basel III Liquidity Standards						
Liquidity coverage ratio	**Observation period begins**				**Introduce minimum standard**				
Net stable funding ratio	**Observation period begins**							**Introduce minimum standard**	

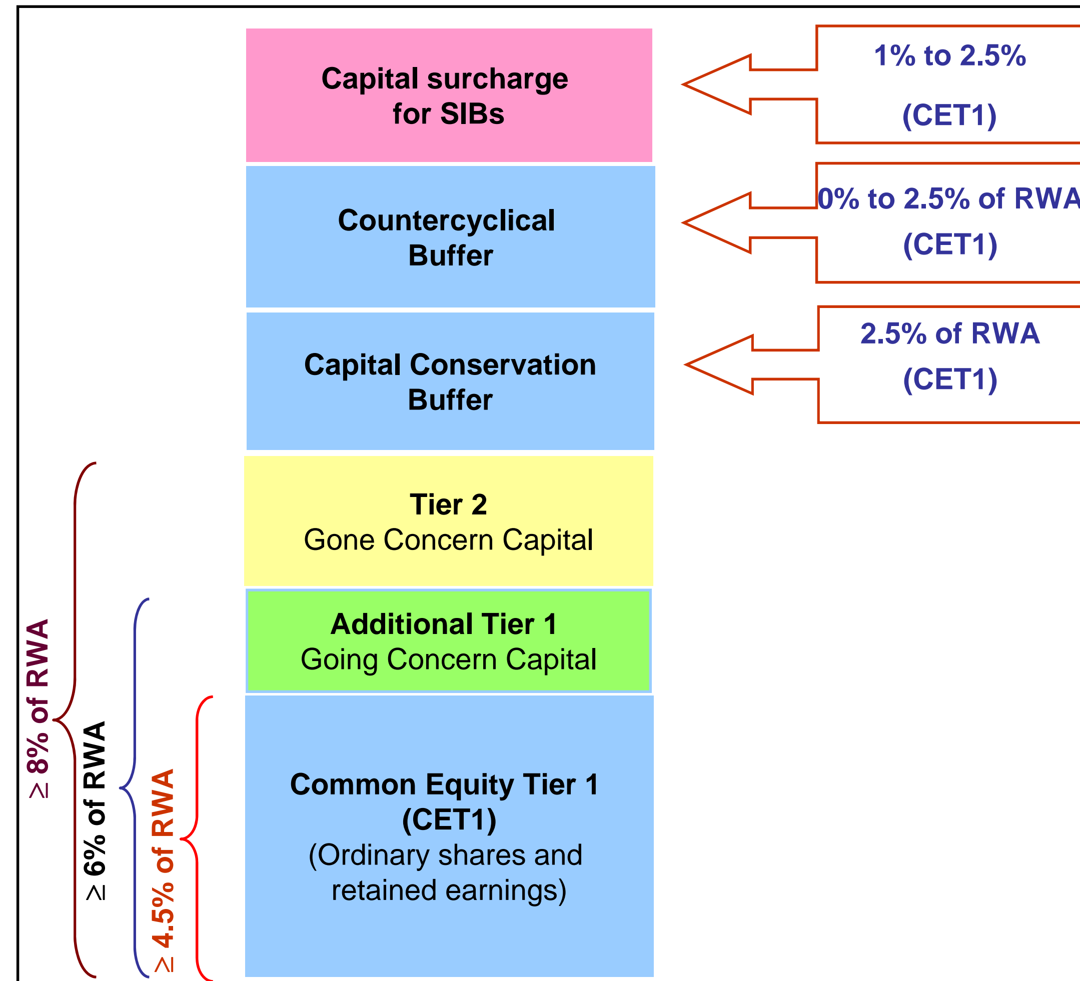
Annex B

Definition of Capital

Basel II (Current)



Basel III (Future)



Annex C

Criteria for classification as ordinary shares for regulatory capital purposes

1. Represents the most subordinated claim in liquidation of the bank.

2. Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).

3. Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).

4. The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.

5. Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).

6. There are no circumstances under which the distributions are obligatory. Non payment is therefore not an event of default.

7. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.

8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur[1]. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others.

9. The paid in amount is recognized as equity capital (i.e. not recognized as a liability) for determining balance sheet insolvency.

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[1] In cases where capital instruments have a permanent write-down feature, this criterion is still deemed to be met by common shares.

10. The paid in amount is classified as equity under the relevant accounting standards.

11. It is directly issued and paid-in and the bank cannot directly or indirectly have funded the purchase of the instrument.

12. The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity[2] or subject to any other arrangement that legally or economically enhances the seniority of the claim.

13. It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners.

14. It is clearly and separately disclosed on the bank's balance sheet.

Criteria for inclusion in Additional Tier 1 Capital

1. Issued and paid-in.

2. Subordinated to depositors, general creditors and subordinated debt of the bank.

3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors.

4. Is perpetual, i.e. there is no maturity date and there are no step-ups or other incentives to redeem.

5. May be callable at the initiative of the issuer only after a minimum of five years:
   (a) to exercise a call option a bank must receive prior supervisory approval; and
   (b) a bank must not do anything which creates an expectation that the call will be exercised; and
   (c) banks must not exercise a call unless:
      (i) they replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank[3]; or

[2] A related entity can include a parent company, a sister company, a subsidiary or any other affiliate. A holding company is a related entity irrespective of whether it forms part of the consolidated banking group.

[3] Replacement issues can be concurrent with but not after the instrument is called.

(ii) the bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised[4].

6. Any repayment of principal (e.g. through repurchase or redemption) must be with prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given.

7. Dividend / coupon discretion:
   (a) the bank must have full discretion at all times to cancel distributions / payments[5];
   (b) cancellation of discretionary payments must not be an event of default;
   (c) banks must have full access to cancelled payments to meet obligations as they fall due; and
   (d) cancellation of distributions / payments must not impose restrictions on the bank except in relation to distributions to common stockholders.

8. Dividends / coupons must be paid out of distributable items.

9. The instrument cannot have a credit sensitive dividend feature, that is a dividend / coupon that is reset periodically based in whole or in part on the banking organization's credit standing.

10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.

11. Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:
   (a) reduce the claim of the instrument in liquidation;
   (b) reduce the amount re-paid when a call is exercised; and
   (c) partially or fully reduce coupon / dividend payments on the instrument.

12. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor

[4] Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.

[5] A consequence of full discretion at all times to cancel distributions/payments is that "dividend pushers" are prohibited. An instrument with a dividend pusher obliges the issuing bank to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term "cancel distributions/payments" means extinguish these payments. It does not permit features that require the bank to make distributions/payments in kind.

can the bank directly or indirectly have funded the purchase of the instrument.

13. The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.

14. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity[6] or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.

15. The instrument includes provisions to address the minimum requirements to ensure loss absorbency at the point of non-viability as described in **Appendix**.

Criteria for inclusion in Tier 2 Capital

1. Issued and paid-in.

2. Subordinated to depositors and general creditors of the bank.

3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general bank creditors.

4. Maturity:
   (a) minimum original maturity of at least five years;
   (b) recognition in regulatory capital in the remaining five years before maturity will be amortised on a straight line basis; and
   (c) there are no step-ups or other incentives to redeem.

5. May be callable at the initiative of the issuer only after a minimum of five years:
   (a) to exercise a call option a bank must receive prior supervisory approval;
   (b) a bank must not do anything that creates an expectation that the call will be exercised[7]; and

[6] An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

[7] An option to call the instrument after five years but prior to the start of the amortisation period will not be viewed as an incentive to redeem as long as the bank does not do anything that creates an expectation that the call will be exercised at this point.

(c) banks must not exercise a call unless:
    (i) they replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank[8]; or
    (ii) the bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised[9].

6. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.

7. The instrument cannot have a credit sensitive dividend feature, that is a dividend / coupon that is reset periodically based in whole or in part on the banking organization's credit standing.

8. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

9. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital.

10. The instrument includes provisions to address the minimum requirements to ensure loss absorbency at the point of non-viability as described in **Appendix**.

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[8] Replacement issues can be concurrent with but not after the instrument is called.

[9] Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.

Appendix

Minimum requirements to ensure loss absorbency at the point of non-viability

Scope and post trigger instrument

1. The terms and conditions of all non-common Tier 1 and Tier 2 instruments issued by an internationally active bank must have a provision that requires such instruments, at the option of the relevant authority, to either be written off or converted into common equity upon the occurrence of the trigger event unless:

   (a) the governing jurisdiction of the bank has in place laws that (i) require such Tier 1 and Tier 2 instruments to be written off upon such event, or (ii) otherwise require such instruments to fully absorb losses before tax payers are exposed to loss;
   (b) a peer group review confirms that the jurisdiction conforms with clause (a); and
   (c) it is disclosed by the relevant regulator and by the issuing bank, in issuance documents going forward, that such instruments are subject to loss under clause (a) in this paragraph.

2. Any compensation paid to the instrument holders as a result of the write-off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies).

3. The issuing bank must maintain at all times all prior authorisation necessary to immediately issue the relevant number of shares specified in the instrument's terms and conditions should the trigger event occur.

Trigger event

4. The trigger event is the earlier of: (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (2) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority.

5. The issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

Group treatment

6. The relevant jurisdiction in determining the trigger event is the jurisdiction in which the capital is being given recognition for regulatory purposes. Therefore, where an issuing bank is part of a wider banking group and if the issuing bank wishes the instrument to be included in the consolidated group's capital in addition to its solo capital, the terms and conditions must specify an additional trigger event. This trigger event is the earlier of: (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the home jurisdiction; and (2) the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction.

7. Any common stock paid as compensation to the holders of the instrument must be common stock of either the issuing bank or of the parent company of the consolidated group (including any successor in resolution).

Annex D

Implementation of Basel III capital standards among different jurisdictions[1]

Part A – Minimum requirements and implementation timeframe

	MINIMUM RATIO REQUIREMENTS				BUFFER REQUIREMENTS	
	Common Equity Tier 1 ratio	Tier 1 capital ratio	Total capital ratio	Implementation timeline	Capital conservation buffer	Implementation timeline
BCBS	4.5%	6.0%	8.0%	Gradual from 2013 to 2015	2.5%	Gradual from 2016 to 2019
Australia	4.5%	6.0%	8.0%	In full from 2013	2.5%	In full from 2016
Mainland China	5.0%	6.0%	8.0%	National SIB[2] from 2013 Others from 2016	2.5%	National SIB by 2013 Others by 2016
European Union[3]	4.5%	6.0%	8.0%	Gradual from 2013 to 2015	2.5%	Gradual from 2016 to 2019
Hong Kong	4.5%	6.0%	8.0%	Gradual from 2013 to 2015	2.5%	Gradual from 2016 to 2019
India	4.5%	6.0%	9.0%	In full from 2013	2.5%	Gradual from 2015 to 2018
	5.5%	7.0%	9.0%	Gradual from 2013 to 2015		
Japan	4.5%	6.0%	8.0%	Gradual from 2013 to 2015	2.5%	Gradual from 2016 to 2019
New Zealand	4.5%	6.0%	8.0%	In full from 2013	2.5%	In full from 2014
Singapore	4.5%	6.0%	8.0%	In full from 2013	2.5%	Gradual from 2016 to 2019
	6.5%	8.0%	10.0%	Gradual from 2013 to 2015		
United States	Please refer to Part B					

[1] Table compiled based on latest policy intentions among jurisdictions as of 23 May 2012.
[2] "SIB" is a short form for "systemically important banks"
[3] Under current draft regulation, member states may be permitted to impose more stringent requirements than Basel III, but the manner in which, and the extent to which this can be done are still subject to negotiation with the European Parliament.

Part B: Implementation status

Hong Kong	Banking (Amendment) Ordinance 2012 enacted by Legislative Council on 29 February 2012 empowering the MA to make rules for Basel 3 implementation. Consultation on policy proposals underway. Draft rules scheduled to be published in Q3/2012 for consultation before being introduced into Legislative Council in Q4/2012.
Australia	Draft rules issued on 30 March 2012 for two months consultation prior to negative vetting by parliament.
Mainland China	Public consultation on draft regulation ended in 2011. Final regulation expected to come into force in Q3/2012.
European Union	Third compromise text (directive and regulation) discussed by the Economic and Financial Affairs Council in May 2012 with a view to negotiations with the European Parliament for adoption at first reading, if possible, by June 2012.
India	Regulation published in May 2012.
Japan	Final rules published in March 2012.
Singapore	Public consultation on draft rules ended in February 2012. Final rules expected to be published in mid-2012.
United States	Draft regulation planed to be issued for consultation during Q2/2012.

Annex E

Consultative proposals on implementation of Basel III capital standards in Hong Kong – Principal industry submissions and MA's responses

Overview:

The following set out a few areas which MA plans to propose modification to its Basel III implementation proposals to address prudential concerns and specific local circumstances, and the latest position of the industry consultation on these issues–

(a) On **double gearing** (in respect of investments in the capital of financial institutions that are outside the regulatory scope of consolidation). Basel III allows exemption from capital deduction amount of such investments up to a threshold level of 10% of a bank's CET1 capital. MA initially proposed a simple full-deduction approach in order to minimise double-gearing within the financial system, and sought comments from the industry as to the potential ramifications this approach might have on AIs' business activities in relation to, for example, market-making, proprietary trading, or investing in the capital instruments of other banks. The industry, as anticipated, raised concerns with regard to level playing field issues, the genuine intention behind the holding of the relevant investments, and the impact on such business activities as market-making. After further consideration, **MA has indicated to the industry that it will adopt the same approach as in Basel III in this respect**.

(b) On the **timing of phase-in for deductions from capital**. Basel III's transitional timeline provides for a five-year straight-line phase-in of the deductions to CET1 (at increments of 20% a year)[1]. MA proposed to adopt the phase-in approach for items not currently required to be deducted under the Banking (Capital) Rules, in order to enable AIs to adjust their capital positions gradually. However, for items already subject to deduction on an equal basis from Core and Supplementary Capital under the existing Banking (Capital) Rules, MA initially proposed that there should be no phase-in,

[1] During the transition period, the remainder not deducted from CET1 will continue to be subject to existing national treatment.

considering not only that AIs were accustomed to these deductions but also the relatively high CET1 levels of local banks. That said, as the industry has requested a phase-in period for deductions to CET1 to assist in capital planning, **MA (after confirming Basel III compliance) has agreed to institute a phase-in arrangement**.

(c) On **recognition of unrealised gains on revaluation of assets**. Basel III allows all unrealised gains on the balance sheet to be included in the determination of CET1. MA initially proposed to adopt the Basel III approach of allowing unrealised gains on fair-valued securities to be included in determining CET1 capital, but it had some reservations as to the extension of the same treatment to loans and receivables as they were usually intended to be held for interest income rather than for gains on disposal. The industry noted that such portfolios were subject to similarly robust valuation standards as applicable to securities valued at fair value, and that derecognition of revaluation gains for loans and receivables might create an asymmetric treatment if they were hedged with derivatives. **MA has subsequently agreed to take onboard the industry's submission with regard to fair-valued loans and receivables.** This notwithstanding, in respect of unrealised gains on own-use and investment properties, MA retains its concerns that recognising unrealised property revaluation gains fully in CET1 may have the potential to materially overstate the CET1 measure in the context of a volatile property market (such as Hong Kong)[2]. MA is therefore minded to retain the current position in the Banking (Capital) Rules[3] of recognizing unrealised gains on property revaluation only in Tier 2 capital and subjecting such gains to a 55% haircut (i.e. only recognising 45% of such gains).

(d) On **exclusion of deferred tax assets relating to timing differences and mortgage servicing rights in the calculation of CET1**. While Basel III allows exemption from capital deduction amount of each of these items, up to a threshold level of 10% of a bank's CET1 capital, MA has reservations as to whether they have genuine loss absorption ability[4], and proposes full deduction of them in the

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[2] Rapidly declining CET1 ratios (say, when there is a rapid fall in property prices in future) may affect banks' ability to support and continue their lending activities, thereby creating potential spillover effects for the real economy.

[3] See sections 38(a), 38(d)(iv), 42(1)(a) and 43 of the Banking (Capital) Rules.

[4] Deferred tax assets can only be reversed over time, thus at best they represent some future potential for reducing profits tax payable and hence increase in earnings. Mortgage servicing rights, created by capitalizing future income streams from the servicing of mortgage loans which have been sold, are not common in Hong Kong where the mortgage securitisation market is not active.

calculation of the regulatory capital base. MA is seeking further views from the industry on this issue.

(e) On the inclusion of an **anti-avoidance provision for exposures to connected entities that may be characterized as loans but which in essence are capital investments**, MA seeks to further circumscribe the proposed anti-avoidance provision along the existing section 48(2)(f) of the Banking (Capital) Rules, in view of concerns raised by the industry. Credit exposures to connected companies are required to be treated as capital investments unless an AI can demonstrate that such credit exposures are incurred in the ordinary course of business.

(f) BCBS has not explicitly addressed the integration of capital charges imposed under **Pillar 2 of the Basel II capital adequacy framework into Basel III**, which primarily focuses on Pillar 1 requirements. MA takes the view that the existing Pillar 2 capital "add-on" should be retained to reflect specific risks not captured under Pillar 1, so this will entail an "add-on" to the three new minimum risk-weighted capital ratios under Basel III. MA is reviewing its Pillar 2 framework to remove any potential for overlap between Pillar 2 capital add-on and the Basel III capital buffer, and is engaging the industry on a viable way forward.

Further details of the industry concerns and MA's responses are enclosed at **Appendix**.

Annex E (Appendix)

Consultative proposals on implementation of Basel III capital standards in Hong Kong – Details on principal industry submissions and MA's response

Items	Industry Comments	MA's response
1. Concessionary thresholds for deduction of capital investments in non-consolidated financial institutions	As allowed under Basel III, instead of full deduction from capital as proposed by the MA, concessionary thresholds should be made available as provided for under Basel III – see Diagram 1 attached to this table for illustration of the application of a "10% concessionary threshold".	The MA will make available the concessionary thresholds in order: (i) to allow for market making activity and the normal proprietary trading of banks which inevitably involve the holding of investments in other financial institutions; and (ii) not to disincentivise investment in financial institutions regionally.
2. Phase-in of current 50/50 deductions to CET1 deductions	A transitional period (from 2014 to 2018) should also be taken as available under Basel III for the phasing-in of those deductions in the calculation of capital which under Basel III are required to be deducted from CET1 but which are currently deducted on an equal basis from Core Capital and Supplementary Capital. – see Diagram 2 attached to this table for illustration.	The MA confirms that a phase-in period will be instituted.
3. Unrealized gains on own-use / investment properties	As permitted under Basel III, unrealized gains on own-use and investment properties should be fully included in calculating the capital base, and should be included in the highest quality (most loss absorbing) tier of capital, i.e. common equity tier 1 ("CET1").	The MA remains of the view that it is prudent to only allow limited recognition of unrealized gains on own-use and investment properties (i.e. with 55% haircut) in tier 2 capital (which is the current approach under the existing Banking (Capital) Rules) because of (i) the historical price volatility of commercial property in Hong Kong, and (ii) the fact that for some banks the amount of property revaluation gains (even with a 55% haircut) will be substantial in relation to their CET1 capital.
4. Deferred tax assets and mortgage servicing rights	Concessionary treatment as provided for under Basel III for limited recognition (up to a threshold) of (i) deferred tax assets ("DTAs") relating to temporary timing differences (arising by virtue of recognition of items in tax computations required by law at a different time from	The present approach is to exclude these items from capital, because the MA does not consider that DTAs or MSRs can be unequivocally relied upon to be available to absorb losses. DTAs can only be reversed over time, thus at best they represent some

Items	Industry Comments	MA's response
	recognition in applicable accounting standards) and (ii) mortgage servicing rights ("MSRs") (relating to future income streams from the serving of mortgage portfolios which have been sold) in calculating capital base should be allowed.	future potential for reducing profit tax payable and hence increase in earnings. So far as MSRs are concerned, there is not an active mortgage securitization market in Hong Kong and so there is little experience upon which to base a robust judgement regarding continued availability of income from MSRs, in times of stress, to absorb losses. The MA is inclined to maintain the existing deduction approach but is open-minded to further comments from the industry.
5. Anti-avoidance provisions	"Anti-avoidance provisions" designed to subject credit exposures of authorised institutions ("AIs") into other entities to the same stringent treatment for capital investments should not be included in the revised capital framework in Hong Kong. Credit exposures do not create double-gearing if not recognized as capital by the investee company and roll-over of loans in common practice are not indicative necessarily of a capital investment.	The MA has sought to circumscribe the provision so that it only applies in exceptional circumstances to credit exposures to companies connected with an AI and, in effect, largely reflects the existing approach in our current Banking (Capital) Rules. In such cases, credit exposures to connected companies are required to be treated as capital investments unless the AI can demonstrate to the satisfaction of the MA that the credit exposures are incurred in the ordinary course of business.
6. Dividend proposed or declared	Treatment of dividends should follow the accounting treatment as stated in Basel III, where dividends are netted from retained earnings after they have been declared. This contrasts with the more conservative approach under the current framework, which the MA proposed to retain, requiring retained earnings to be net of dividends that are proposed or declared, not only before, but also after, the end of the financial year.	On the basis that AIs will be expected to take a conservative approach to the payment of dividends in cases where their capital base is under pressure, the MA is minded to accept the industry's proposed approach.
7. Revaluation gain / loss on loans and receivables available for sale ("AFS") or	As allowed under Basel III, revaluation gains and losses on AFS or FVO loans and receivables should be recognized in the calculation of capital base.	While accepting the industry's proposal for allowing revaluation gains and losses on AFS and FVO loans and receivables to be included in the calculation of capital base on account of their being subject to the

Items	Industry Comments	MA's response
designated for fair value option ("FVO")		prudential valuation guidance issued by the MA, the MA will focus on the governance arrangements and systems and controls in place within AIs to ensure compliance with the guidance.
8. Trigger point for AT1 capital instruments	A higher trigger point for principal loss absorption (which forms part of the qualifying criteria for AT1 instruments in the form of liabilities) than the minimum requirement under Basel III (6.25% was proposed as opposed to 5.125%) will place banks in Hong Kong at a competitive disadvantage relative to international banks.	The proposed 6.25% trigger point sought to reflect an average Pillar 2 add-on in the CET1 capital ratio. Having considered the industry's comment, and given that the 5.125% trigger point set by the BCBS appears likely to be adopted by most other major jurisdictions, the MA is inclined, on balance, to adopt 5.125% as the trigger level.
9. Minority interest ("MI") held by third parties in consolidated subsidiaries	Minimum ratios used for the calculation of MI should be consistent with the minimum ratios required by the MA for subsidiary banks in Hong Kong. If the MA includes Pillar 2 in the minimum ratios, the same ratios should be used for the calculation of MI. Otherwise, there are discrepancies in the definitions of the minimum ratios for the holding bank and the subsidiary bank. This is not appropriate especially when both are regulated by the MA in Hong Kong.	The Pillar 2 add-on will remain part of the minimum capital requirement under Basel III. Logically, eligible MI should be based on the actual minimum capital requirements rather than the basic Basel III Pillar 1 minima. The MA is open to adopting the industry's suggestion, but would like to hear from the industry whether and to what extent the resultant potential disclosure of the Pillar 2 add-on would be of concern.
10. Pillar 2 Integration	The industry queried the need for retaining the Pillar 2 capital add-on in the light of the buffer requirements under Basel III and raised concerns regarding the MA's proposed approach of apportioning the Pillar 2 add-on between CET1/Tier1/Total Capital on a pro-rata basis in accordance with the Pillar 1 split for the three ratios in terms of: (i) comparative disadvantage vis-à-vis other jurisdictions not adopting the same approach, and (ii) effective disclosure of hitherto confidential Pillar 2 add-on.	The MA considers that under Basel 3 there is a need to retain the Pillar 2 process, which complements Pillar 1 by addressing risks not captured, or not adequately captured, under Pillar 1. In contrast, the Basel 3 capital buffers do not address specific risks in the same way as the Pillar 2 process, and instead are intended to be general cushions of capital above the minimum to be available for use during periods of stress. The MA therefore remains of the view that, to the extent that a Pillar 2 add-on reflects specific risks not

Items	Industry Comments	MA's response
		captured or not adequately captured under Pillar 1, there is a need to retain the add-on as part of the minimum capital requirement. To the extent however that there is any element within the Pillar 2 process of a cushion of capital being added to bolster resilience generally without reference to a specific Pillar 2 risk, the MA acknowledges there may be a degree of overlap. The MA has therefore undertaken to review its Pillar 2 framework to remove any such overlap. Any portion of the Pillar 2 capital add-on that caters for AI-specific risks and hence falls outside the overlap will represent a minimum capital requirement and the MA is of the view that logically the same principle should apply in determining how the Pillar 2 add-on should be constituted as applies in the case of the Pillar 1 charge.
	The proposed apportionment approach will also have knock-on effects on the CET1 ratio to be set as a trigger point for conversion / write-down of AT1 capital instruments which are liabilities and on the recognition of minority interest in banking subsidiaries.	See MA's responses to items 8 and 9 above.
11. Qualifying central counterparties ("CCPs")	For determining a "qualifying central counterparty" for which preferential treatment can be applied in calculating capital charges for banks' counterparty credit risk exposures, the BCBS's current approach is that banks should make their own assessment if the regulator of a relevant CCP does not make available its view on whether the CCP is qualifying. In contrast, the industry has requested a list of qualifying CCPs in order not to duplicate effort among banks in the assessment process.	The MA is exploring with the industry whether an "industry-led approach" may work for CCPs. This would involve the industry associations in coordinating a template for completion in respect of a given CCP – with the result of the completion of the template identifying whether the CCP is qualifying. More work is needed and developments are still ongoing internationally. This issue is not unique to Hong Kong and the MA is observing developments

Items	Industry Comments	MA's response
		elsewhere.
12. Applying Standardized Approach on non-qualifying CCPs	The BCBS is proposing that banks must use the Standardised Approach to the calculation of credit risk in calculating the credit risk capital requirement on trade exposures to non-qualifying CCPs. Permission is sought for the use of the Internal Ratings-Based ("IRB") Approach to the calculation of credit risk for non-qualifying CCP exposures. Also, a non-IRB guarantee cannot be recognized as credit risk mitigation to an IRB credit risk exposure under the current BCR framework, and vice versa. As a result, if a non-qualifying CCP must be a standardized counterparty, an IRB guarantee of the non-qualifying CCP's performance cannot be recognized under the MA's requirement.	In view of the level playing field issue as well as the need for regulatory consistency, the MA is inclined to follow the calculation methodology proposed by the BCBS (i.e. the Standardized (credit risk) ("STC") Approach must be used for non-qualifying CCP exposures). When an AI that uses the IRB Approach is required to use the STC Approach to calculate the credit risk of an exposure, the AI must assess the eligibility of any guarantees provided to the exposure using the criteria under the STC Approach and determine the risk-weight applicable to the guarantors by using the STC Approach. As the two sets of recognition criteria for guarantees under the two calculation approaches are not contradictory (but indeed have many similarities), it should not be the case that IRB guarantees are always ineligible for recognition under the STC Approach. As a result, the MA does not anticipate that the recognition of a guarantee under the STC Approach would be a significant issue for an IRB AI as far as non-qualifying CCP exposures are concerned.

Diagram 1 - 10% concessionary threshold for deduction of capital investments in non-consolidated financial institutions

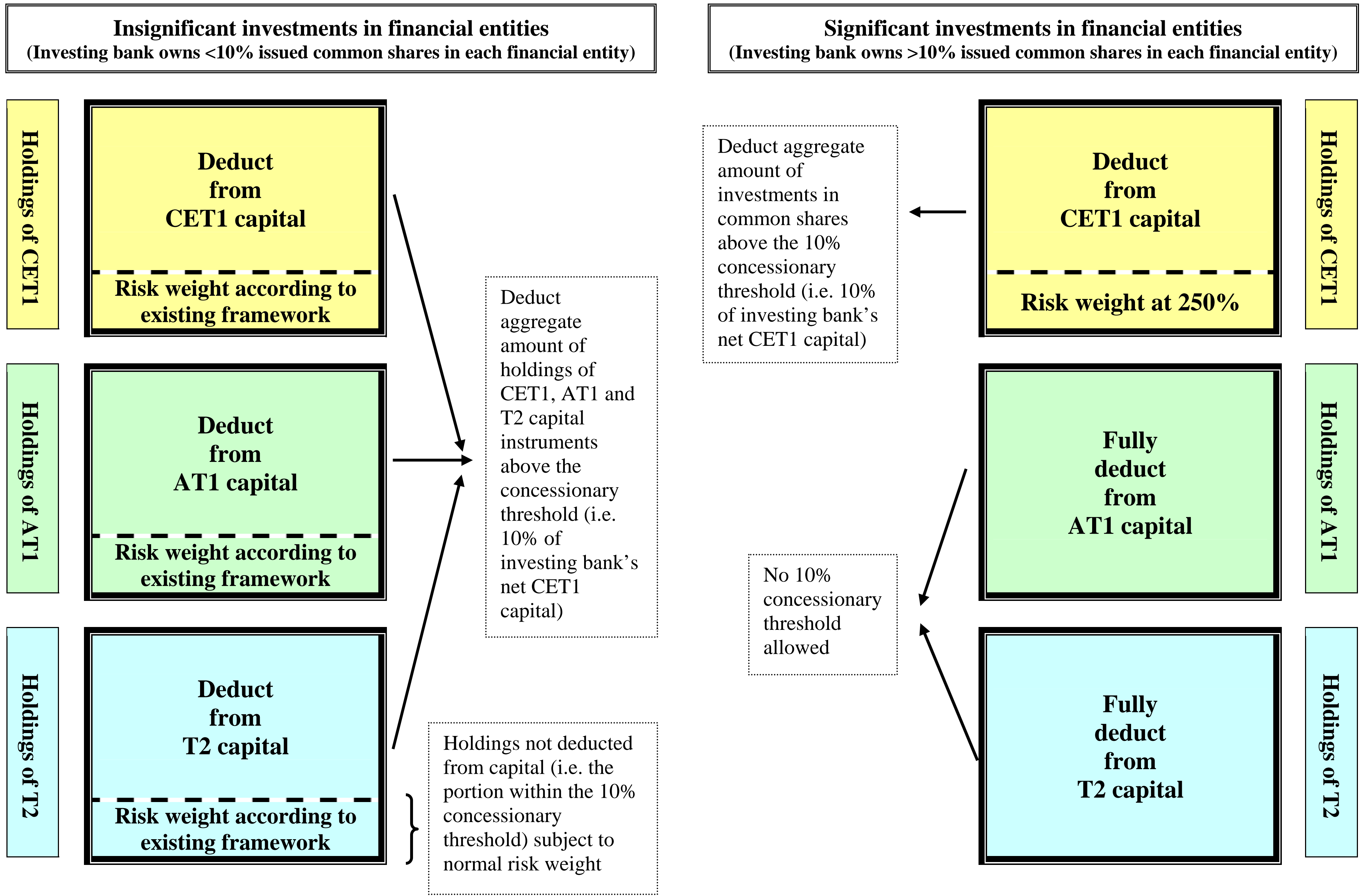

Diagram 2 - Phase-in of current 50/50 deductions to CET1 deductions

	2013	**2014**	**2015**	**2016**	**2017**	**2018**
Portion deducted from CET1	0%	20%	40%	60%	80%	100%
Remaining portion	100%	80%	60%	40%	20%	0%
deducted from :						
Tier 1	*50%*	*40%*	*30%*	*20%*	*10%*	*0%*
Tier 2	*50%*	*40%*	*30%*	*20%*	*10%*	*0%*

BANKING (SPECIFICATION OF MULTILATERAL DEVELOPMENT BANK) NOTICE (Cap. 155N)

Under section 2(19) of the Banking Ordinance ("BO", Cap. 155), MA may by notice published in the Gazette specify any bank or lending or development body established by agreement between, or guaranteed by, 2 or more countries, territories or international organizations other than for purely commercial purposes as a multilateral development bank ("MDB") for the purposes of the BO. Currently, 13 institutions are specified in the Banking (Specification of Multilateral Development Bank) Notice as MDBs based on the list set out in the Basel II capital framework.

Preferential regulatory treatments for MDBs

2. Because of the special status of MDBs and their perceived creditworthiness, exposures to MDBs are afforded the following preferential regulatory treatments under the BO and the Banking (Capital) Rules (Cap. 155L):

(a) claims on MDBs are eligible for a 0% risk-weight under the Standardized (Credit Risk) Approach[1] and exposures which are guaranteed against convertibility and transfer risk by MDBs can be risk-weighted by using the borrowers' domestic currency ratings instead of their foreign currency ratings. In general, a borrower's domestic currency rating will attract a lower risk-weight than a foreign currency rating;

(b) marketable debt securities[2] issued or guaranteed by MDBs can be included as liquefiable assets with a high liquidity conversion factor[3] for the purpose of calculating the statutory liquidity ratio that authorized institutions ("AIs") must maintain under section 102(1) of the BO; and

(c) AIs' financial exposures to MDBs are not subject to the large exposure limitation imposed by section 81(1) of the BO.

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[1] "Standardized (Credit Risk) Approach" is equivalent to the Standardised Approach, which is one of the approaches set out in the Basel II capital framework that banks may choose for the calculation of the capital requirement for credit risk. The main feature of this approach is that credit exposures are risk-weighted by reference to credit assessments provided by external credit assessment institutions recognised by banking supervisors.

[2] "Marketable debt securities" is defined in the Fourth Schedule to the BO to mean "debt securities which have an established secondary market in Hong Kong or elsewhere in which they can be sold readily".

[3] Simply speaking, the liquidity ratio is calculated as a ratio of liquefiable assets to qualifying liabilities. A higher liquidity conversion factor assigned to a liquefiable asset will result in a higher liquidity ratio.

BCS' decision to include Multilateral Investment Guarantee Agency ("MIGA") in MDB list

3. In May 2010, BCBS included MIGA in the list of MDBs set out in the Basel II capital framework so that supervisors may allow banks to apply a 0% risk-weight to claims on MIGA. The decision of the BCBS was on the ground that MIGA has a strong shareholder structure (e.g. 59% of MIGA's shares are held by sovereigns with a credit rating of AA- or better), strong shareholder support, adequate levels of capital and liquidity, strict statutory lending requirements, and it would be rated AAA if it sought a credit rating.

4. MIGA is a member of the World Bank Group. It was established to encourage the flow of investments for productive purposes among member countries, particularly developing member countries, by providing political risk insurance for investments in these countries. MIGA can issue insurance coverage against the risks of convertibility and transfer restrictions, expropriation, war and civil disturbance, breach of contract and the non-honoring of sovereign financial obligations.

Amendment to implement BCBS' decision

5. MA is supportive of BCBS' decision and is satisfied that MIGA meets the requirement set out in section 2(19) of the BO for being declared by the MA as a MDB. MA therefore proposes to amend the Banking (Specification of Multilateral Development Bank) Notice to include MIGA as a MDB.

Industry consultation

6. MA consulted The Hong Kong Association of Banks and The DTC Association in December 2010 on the proposal to specify MIGA as a MDB. Both Associations are supportive of the proposal.

Implementation date

7. We plan to table the Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 for negative vetting by the Legislative Council in Q4/2012, and expect the amendment to come into effect from 1 January 2013.