HONG KONG MONETARY AUTHORITY
香港金融管理局

Our Ref: B1/15C
S4/3C
S5/1C

26 January 2011

The Chief Executive
All Authorized Institutions

Dear Sir/Madam,

Implementation of Basel III in Hong Kong

On 13 January 2011, the Basel Committee on Banking Supervision (BCBS) issued the final element of the new regulatory capital requirements, namely the *Minimum requirements to ensure loss absorbency at the point of non-viability*. This followed the earlier release, on 16 December 2010, of the final text of the Basel III rules, as set out in *Basel III: A global regulatory framework for more resilient banks and banking systems* and *Basel III: International framework for liquidity risk measurement, standards and monitoring*[1].

The HKMA, as a member of the BCBS, is supportive of the underlying objective of the Basel III reform package to strengthen the resilience of the banking sector against cyclical economic shocks and therefore intends to fully implement the reform package in Hong Kong. To this end, this letter sets out some of the HKMA's initial thinking on implementation (including the anticipated timetable) in order to provide authorized institutions (AIs) with a backdrop against which to develop their own plans for bringing their organizations into compliance with the Basel III requirements. Some policy issues currently under consideration by the HKMA are also highlighted.

[1] The Basel III documents are available on the website of the Bank for International Settlements (www.bis.org).

55th Floor, Two International Finance Centre,
8 Finance Street, Central, Hong Kong
Website: www.hkma.gov.hk

香港中環金融街8號國際金融中心2期55樓
網址：www.hkma.gov.hk

Overview of the Basel III requirements

As you will be aware the main elements of the Basel III reform package include:-

1. **Strengthening the global capital framework**

(i) The quality of the regulatory capital base will be enhanced by:

- introducing a more stringent definition of, and qualifying criteria for, Tier 1 and Tier 2 capital. This includes the removal of incentives to redeem and the inclusion of a requirement that the contractual terms of any non-common equity capital instruments must allow them to be written-off (or converted into common shares) in the event that a bank is determined by a relevant authority to be non-viable or receives a public sector injection of capital (or equivalent support) without which it would have become non-viable; and

- harmonising regulatory adjustments (i.e. deductions) to the capital base and providing that in most cases these should be deducted from the common equity component of the capital base.

(ii) The minimum regulatory capital requirements in relation to risk-weighted assets will be increased, with:

- the common equity requirement rising from 2% (before the application of regulatory adjustments) to 4.5% (after the application of stricter regulatory adjustments); and

- the Tier 1 capital requirement rising from 4% to 6%.

The total minimum capital requirement remains unchanged at 8%.

(iii) The transparency of the capital base will be improved, with all elements of capital being required to be disclosed along with a detailed reconciliation to the reported accounts.

2. **Reducing procyclicality**

In "normal" times, outside of periods of financial and economic stress, banks should hold buffers of capital above the regulatory minimum capital requirement. For this purpose, Basel III establishes a "**capital conservation buffer**" of 2.5% of risk-weighted assets comprised of common equity (after the application of regulatory adjustments). Restraints will be imposed on distributions by a bank when its capital level falls into the conservation buffer range. In a measure to

address the cyclicality of the capital framework and counteract any tendency towards procyclicality, Basel III provides for the range of the capital conservation buffer to be extended in periods of excessive aggregate credit growth by the add-on of a "**countercyclical capital buffer**". This countercyclical capital buffer may range from 0% in normal times up to 2.5% of risk-weighted assets during periods of excessive credit growth associated with the build-up of system-wide risk.

3. Supplementing the risk-based capital requirement with a leverage ratio

Basel III provides for the introduction of a simple leverage ratio designed to constrain the build-up of excessive leverage in the banking sector. The leverage ratio will provide an additional safeguard against model risk and measurement error in the risk-based capital adequacy calculation.

4. Enhancing risk coverage

The capital requirements for counterparty credit risk (CCR) exposures in banks' derivatives, repo and securities financing activities will be strengthened. This will be achieved through a variety of measures including: the imposition of capital charges for mark-to-market losses; and the use in the capital calculation of stressed inputs and of an asset value correlation multiplier for exposures to large regulated, and unregulated, financial institutions. Risk management standards for model validation, stress-testing, collateral management and margining requirements will also be strengthened.

The BCBS issued a consultative paper, on 20 December 2010, regarding the *Capitalisation of bank exposures to central counterparties*, setting out proposals for the capital treatment of banks' exposures to central counterparties (CCPs). While providing incentives for banks to increase their use of CCPs to clear OTC derivatives trades, the proposals aim to ensure that the risk arising from banks' exposures to CCPs is adequately capitalised. The BCBS expects to finalise the proposals before the end of this year for implementation by January 2013, as part of the enhanced capital treatment for CCR exposures.

5. Introducing global liquidity standards and monitoring metrics

Basel III introduces two minimum standards for funding liquidity:

(i) the Liquidity Coverage Ratio (LCR) – to ensure that banks have a sufficient stock of high-quality liquid assets to meet contingent liquidity needs and survive for at least 30 days under a supervisor-defined scenario combining an idiosyncratic and market-wide shock; and

(ii) the Net Stable Funding Ratio (NSFR) – to promote banks' use of more stable and longer term funding sources to support their activities. Under this ratio, banks are required to ensure that their estimate of "required stable funding" over a one-year time horizon under conditions of extended stress is met by their estimate of "available stable funding" from reliable funding sources.

Transitional arrangements

The BCBS has specified a set of transitional arrangements for the implementation of the new Basel III standards with a view to ensuring that the banking sector can meet the higher capital and liquidity standards through reasonable earnings retention, capital or fund raising, and other balance sheet adjustments, while still supporting lending to the economy. Implementation will therefore begin on 1 January 2013 with full implementation by 1 January 2019 (although the phase-out of capital instruments issued before 12 September 2010 that no longer qualify as Tier 1 or Tier 2 capital will continue until 2023). The table of transitional arrangements issued by the BCBS is annexed to this letter for ease of reference.

Reporting during observation periods

Given that the leverage and liquidity ratios are new, the BCBS has provided observation periods, within its transitional phase-in arrangements, to allow the ratios' operation and effects to be monitored before they are formally implemented as minimum standards. Robust data reporting and assessment processes will be put in place during these observation periods, entailing additional QIS-type exercises commencing later this year, followed by the introduction of a more formal regulatory reporting framework. To give banks time to develop their reporting systems, it is anticipated that the first formal reporting return will be required to be submitted in or around January 2012. The HKMA will inform AIs of the reporting arrangements once finalized by the BCBS.

Impact of the new requirements on AIs

Given that banks in Hong Kong are well-capitalised and have traditionally placed significant reliance on common equity to meet regulatory capital requirements and that most of the Basel III regulatory adjustments are already required to be deducted from Tier 1 capital under Hong Kong's existing capital rules, Hong Kong banks should have little difficulty in meeting the higher capital requirements. Similarly, the HKMA does not expect major problems for banks in Hong Kong to comply with the new

liquidity standards, although some may need to adjust their liquidity profiles or the composition of their liquid assets.

Implementation programme in Hong Kong

The HKMA's current intention is to adhere to the BCBS implementation timetable, including the transitional arrangements.

The implementation of Basel III in Hong Kong will entail amendment of the Banking Ordinance, Banking (Capital) Rules and Banking (Disclosure) Rules. To meet the deadline for the introduction of the first phase of Basel III as of 1 January 2013 (i.e. the new minimum capital levels and the parallel run of the leverage ratio), the HKMA will ideally need to introduce the necessary legislative amendments within the 2011-2012 legislative session to allow sufficient time for development of supervisory guidelines by the HKMA, and for necessary operational changes and systems enhancements by AIs. Given this schedule, the HKMA would anticipate starting to conduct the required statutory consultation on the draft amendments to the Ordinance and Rules in the third or fourth quarter of 2011.

The optimal approach (in terms of the mix of: primary legislation, subsidiary legislation (rules) and the issuance of supervisory guidance) for the introduction of the Basel III liquidity standards in Hong Kong will necessitate careful consideration given the likelihood of changes being made to the standards during and following the observation periods and the constraints on the legislature's time.

Issues to be addressed

In developing its implementation proposals, the HKMA will be considering:

(i) The interaction and interlinkage between the new capital buffers and the existing Pillar 2 framework.

(ii) The limited supply of eligible high-quality liquid assets, denominated in Hong Kong Dollars, available to meet AIs' liquidity needs for the purposes of the LCR. Under the LCR, the main source of high-quality liquid assets is sovereign or central bank debt and Hong Kong does not have a sufficient supply of such debt in issue. Other types of eligible liquid assets, such as non-financial corporate debt with the requisite ratings, are also in short supply. The BCBS is developing alternative options for jurisdictions in this position and these should be finalised within the observation period for the LCR. Following the completion of the first round of the local QIS on locally incorporated banks last year, the HKMA will be discussing with participating banks their plans to cover any liquidity shortfalls projected from the QIS results. These discussions should help gauge the

potential demand for eligible high-quality liquid assets and the viability of options available to the relevant banks.

(iii) The scope of application of the new liquidity standards. Under Basel III, supervisors have the discretion to apply the liquidity standards on a legal entity or branch basis. The HKMA's current intention is to apply the standards to all locally incorporated AIs, on both a consolidated and unconsolidated basis. Whether, and the extent to which, the liquidity standards should be applied to branches of overseas incorporated AIs is an issue upon which the HKMA wishes to deliberate further. In order to inform its policy decisions, the HKMA will conduct a second round of local QIS, probably in the first quarter of 2011, on selected restricted licence banks, deposit-taking companies and branches of overseas-incorporated banks (these types of AI were not covered in the first round) to assess the impact of the liquidity standards upon them. The outcome of this QIS exercise will also help inform the HKMA's thinking on whether, how and when, the existing 25% statutory liquidity ratio described in the Fourth Schedule to the Banking Ordinance should be retained, revised or phased out.

(iv) The implementation of the advanced CCR calculation methods (i.e. the standardised method and the internal model method). The Basel III reform package enhances the capital treatment available under these advanced methods. However, these advanced methods have yet to be introduced into the capital framework in Hong Kong (earlier assessments undertaken for the purpose of Basel II implementation indicated no immediate need at that time, and subsequent assessments have favoured a wait-and-see approach until the BCBS's amendments were finalised). The HKMA is now considering the feasibility of adopting these advanced methods, together with the Basel III enhancements to the CCR capital framework, with effect from January 2013 in accordance with the BCBS timeline.

Closely related in this area are the Financial Stability Board's proposals for the reform of the OTC derivatives market (in terms of the use of CCPs to reduce CCR in OTC derivatives activities and the use of mandatory trade reporting to increase transparency). As announced by the HKMA and the SFC towards the end of last year, the proposal is for Hong Kong to establish a local CCP and a local trade repository for the clearing and reporting of OTC derivatives trades within the international implementation timeline before the end of 2012. The HKMA is currently in the process of developing supervisory guidance to set out the relevant clearing and reporting standards, and will be seeking input from a variety of AIs. The HKMA expects to issue the guidance for industry consultation during the course of 2011.

(v) Further guidance is expected from the BCBS and the accounting standard-setters during the course of 2011 on more forward-looking expected loss provisioning.

The HKMA is supportive of this initiative and will be monitoring developments. As and when guidance is issued, the HKMA will be consulting the banking industry on the likely impact and implications for the local banking sector.

Next steps for AIs

Basel III, like Basel II, has been developed primarily for internationally active banks. However the established practice in Hong Kong and in many other jurisdictions is to apply the same capital standards to all banks whether internationally active or not. The present intention of the HKMA is therefore to apply the Basel III capital and liquidity standards to all locally incorporated AIs on both a consolidated and unconsolidated basis. The senior management of these AIs are therefore strongly recommended, if they have not already done so, to review the requirements in the final text of Basel III and to consider what changes will need to be made to their organization's capital structure and capital planning; the components of its capital base; its liquidity profile and management; its management information systems; and its IT infrastructure in order to meet the new requirements. AIs incorporated overseas should also consider how their liquidity positions may be impacted if the liquidity standards were to be applied to their branches in Hong Kong. In formulating its proposals for the scope of application of the liquidity standards in Hong Kong, the HKMA will be seeking input and comments from a range of foreign banking institutions.

Over the course of the next few months, the HKMA will be discussing implementation plans with individual AIs. Nevertheless, it would be advisable for any AI which anticipates that it might encounter significant issues in complying with the new requirements to raise these matters with their supervisory contact at the HKMA in advance of such general discussions. The HKMA will shortly be sharing with those banks which participated in the 2010 QIS the results of its assessment of the impact of the Basel III consultative proposals on their capital and liquidity positions. This should facilitate such banks' implementation planning. Meanwhile, the HKMA expects local AIs to have regard to the revised definition of regulatory capital in their capital issuance planning during the interim period up to 1 January 2013.

In preparing for the implementation of Basel III in Hong Kong, the HKMA will continue to work closely with Hong Kong Association of Banks, the Deposit-taking Companies Association and other professional bodies. To facilitate effective and timely consultation on the new liquidity standards, the HKMA is considering convening a joint HKMA-industry working group on liquidity to provide a forum for detailed discussion of the relevant implementation proposals and issues.

Should you have any questions regarding this circular, please feel free to contact your usual supervisory contact at the HKMA.

Yours faithfully,

Karen Kemp
Executive Director (Banking Policy)

Encl.

c.c. FSTB (Attn: Ms Natalie Li)

Annex

Phase-in arrangements

(shading indicates transition periods - all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio	Observation period begins							Introduce minimum standard	