

**Banking (Amendment) Bill 2005 –
Consultation responses and HKMA’s feedback**

Introduction

1. In December 2004, the Hong Kong Monetary Authority (HKMA) consulted on the draft Banking (Amendment) Bill 2005. The main purpose of the Bill is to amend the Banking Ordinance (BO) to provide for the implementation of the requirements under the revised international capital adequacy framework (“Basel II”) promulgated by the Basel Committee on Banking Supervision. This paper summarises the main points raised in the course of the consultation and gives the HKMA’s responses.

The Bill

2. The consultation draft of the Bill mainly covers three major areas, namely the calculation of the capital adequacy ratio (CAR) of Authorized Institutions (AIs), the enhancement of the existing financial disclosure regime applicable to AIs, and the introduction of capital and financial disclosure requirements for bank holding companies (BHCs).

3. In order to improve the working of the BO in light of experience, the Bill also makes a small number of miscellaneous amendments including:

- (a) confining the liability of a manager of an AI for certain contraventions under the BO to the case where the contravention results from an act or omission of the manager himself or a person under his control (instead of extending liability to every manager of the AI, as at present); and
- (b) expressly providing that the MA may publish details of his disciplinary decisions in respect of AIs’ securities business.

4. In addition, the Bill proposes that section 101 of the BO be amended to allow the MA, after consultation with an AI, to vary the CAR of that AI by increasing the ratio to not more than 16%.

Points raised by respondents and the HKMA’s feedback

5. The HKMA received comments from 15 respondents including individual AIs, the Hong Kong Association of Banks, the DTC Association, the Securities and Futures Commission (SFC), the Law Society, the Hong Kong Institute of Certified Public Accountants, the Privacy Commissioner for

Personal Data, the Consumer Council, and other interested parties. We are grateful to those who responded.

6. Respondents raised no major objections to the content of the Bill. Their responses were helpful and positive, and generally were of the nature of seeking clarification on the regulatory intent of certain provisions, and how certain provisions would work in practice.

7. The main issues raised, together with the HKMA's responses, are set out in the paragraphs below.

Disclosure of information relating to financial affairs

8. Clause 2 of the consultation draft of the Bill amends the existing section 60A of the BO to provide for the Monetary Authority (MA) to make rules prescribing public disclosure requirements for AIs on their financial affairs, including CAR. It was commented that the drafting of the clause seems to contemplate that rules made under section 60A(1) would apply to all AIs, rather than different rules applying to different classes of AIs as under the existing section 60A.

9. In addition, it was pointed out that it is imperative for the market to view AIs' capital information within the context of their overall financial situation. Noting that Basel II recommends quarterly disclosure of CARs and some AIs' current practice of publicly disclosing their financial information on a half-yearly basis, the HKMA's assurance was sought that it has no intention to make rules to require AIs which are disclosing their financial information on a half-yearly basis to make quarterly public disclosure only on their CARs.

10. We do not intend to change the current policy of applying different disclosure obligations to different classes of AIs after the implementation of Basel II. To reflect this policy intent and in response to the comment raised, we have amended the proposed section 60A to include a provision that rules made under the section may make different provision for AIs belonging to different classes of AI.

11. The HKMA intends to adopt the Basel II approach whereby Pillar 3 disclosures are to be made on a semi-annual basis, except for (i) certain qualitative disclosures on risk management objectives and policies to be published on an annual basis; and (ii) Tier 1 and total CARs, and their components, to be disclosed on a quarterly basis, where quarterly disclosure statements are produced by the AI. The quarterly disclosure of capital information is not mandatory but encouraged.

The proposed supervisory regime for BHCs

12. Clause 3 of the Bill proposed to add a supervisory regime for BHCs of AIs. Most of the respondents raised no objections to the relevant proposed amendments. However, some of the respondents queried how some aspects of these amendments would be applied in practice. Moreover, there appears to be a general feeling that such a regime is not strictly necessary at this juncture, in particular because no consensus has yet emerged among banking regulators as to how exactly it should be implemented. In light of these comments and the fact that the existing powers of the MA under the BO in respect of controllers of AIs are for the time being broadly adequate to achieve the Basel II objective of ensuring that risks within banking groups can be captured, the HKMA has decided to respond to the industry comments by excluding from the Bill the provisions on BHCs. This will be revisited later when we can see how other key regulators approach the issue.

13. In the meantime, we will develop a Supervisory Policy Manual module, in consultation with the industry, on the topic of consolidated supervision, including the use the MA will make of the existing section 70 provisions in respect of controllers (including, for example, requiring the maintenance of a minimum CAR by certain controllers). This, we consider, would be a sound means of ensuring that Hong Kong's regulatory regime addresses the increased emphasis on consolidated supervision and the regulation of BHCs which is embodied in Basel II, notwithstanding that formal BHC provisions will not be introduced at this stage.

The MA's power to make capital rules

14. Clause 4 of the Bill adds the proposed section 98A to provide for the MA to make rules prescribing the manner of calculation of the CAR of AIs. It was suggested that the proposed section seems to provide the MA with a blanket ability to make rules, whereas the definition of "CAR" in Part 1 of the Schedule of the Bill seems to provide that the rule making ability is limited to credit risks resulting from the diminution in the value of on-balance sheet items. Clarification was therefore sought on the scope of the MA's power to make rules under the proposed section 98A. In addition, it was queried that the Explanatory Paper (which was circulated together with the draft Bill for consultation) stated that the rules made by the MA were to be subject to negative vetting by the Legislative Council (LegCo) but this was not stated in the Bill. There was also a suggestion that section 98A should include the ability of a person aggrieved to make representations to the MA in relation to any decision proposed to be made.

15. As mentioned in the Explanatory Paper it is not the Administration's intention that the MA should have a general rule-making power under the BO: the powers will be confined to those strictly necessary to

ensure the methodology for calculating CAR (as in the case of section 98A) and the requirements for disclosure of financial information (as in the case of section 60A) continue to reflect international best practice. The rule making power in section 98A is constrained by reference to the definition of CAR under the Bill. The term CAR is clearly defined to include credit risk, market risk and operational risk as captured under Pillar 1 of Basel II.

16. The rules to be made by the MA under the BO will fall under the definition of “subsidiary legislation” in the Interpretation and General Clauses Ordinance (i.e. Cap 1) and hence will be subject to negative vetting of LegCo by virtue of s.34 of Cap 1. It is therefore not necessary for the legislation to state that the rules will be subject to negative vetting.

17. Regarding the suggestion that AIs should have the opportunity to make representations before any decision is made under the Capital Rules, the HKMA considers that this is not needed. This is because the rules, which mainly concern the calculation methodologies of CAR, are being developed in close consultation with the industry, and before issuing the rules the MA will be obliged to consult relevant parties, including the industry associations. Moreover, the rules will be subject to negative vetting by LegCo. We believe that any concerns about the detailed working or components of the rules will be addressed before the rules are finalised, and once the rules are issued they should be applied to AIs across the board consistently and continuously. Consequently, the provision for making representation before any decision is made under the rules is not necessary. However, it is the HKMA’s intention to specify that the decision of the MA regarding the calculation approach to be adopted by an AI can be subject to a review by the MA and an appeal to the Chief Executive in Council.

Definition of capital base

18. Clause 3 of Part 1 of the Schedule defines “capital base” to mean paid-up capital, credit balance of share premium account, audited retained earnings, published reserves and such other resources of an AI as the MA may prescribe in Capital Rules. It was pointed out that the proposed definition could include part of an AI’s revaluation reserves which the HKMA would want to exclude from the capital base (e.g. revaluation reserve on cash flow hedges of financial instruments following the implementation of HKAS 39). Therefore, it was suggested that the definition of capital base should allow more flexibility for the MA to prescribe the capital base given the implementation of new accounting standards. We agree with this comment. We are also mindful of the need to specify the extent to which certain capital components can be included as capital base, given the development of innovative capital instruments in the market that may carry special features rendering them not suitable to be regarded as capital. In the light of these considerations, the definition of capital base has been amended to provide the

MA with the discretion of limiting the scope of the various items that constitute the capital base.

Increase of the upper limit of the CAR for licensed banks

19. Clause 5 of the Bill amends section 101(1) to increase to 16% the maximum ratio to which the CAR of a licensed bank may be varied by the MA under that subsection. It was suggested that there may not be sufficient grounds to support the amendment, in view of the high CAR levels maintained by AIs and the introduction of the more risk sensitive capital adequacy framework. It was also queried whether the amendment is needed to give the MA greater flexibility to address special circumstances or, rather, for the implementation of Basel II.

20. The MA's policy intent in respect of the proposed amendment has been spelt out clearly in the Explanatory Paper. The amendment is not driven by the implementation of Basel II in Hong Kong but serves purely to allow the MA more flexibility to set higher minimum CARs should extraordinary circumstances so require. Based on present circumstances, we do not envisage an immediate need for a rise in the minimum CAR of any AI.

Strict liability of managers

21. Clause 7(2) of the Bill amends section 2 of the BO to limit the liability of the managers of an AI for certain contraventions under the BO to cases where the contravention is caused or contributed to by an act or omission on the part of the manager himself or a person under his control. It was suggested that it is unfair to apply strict liability to a manager where the contravention was caused or contributed to by somebody under the control of the manager. It was suggested that the manager should only be liable for the offence if he has not taken reasonable steps to exercise proper control over the subordinate who caused or contributed to the contravention.

22. The HKMA notes that a general defence has already been provided under section 126 of the BO for a manager charged under the BO to prove on a balance of probabilities that he took reasonable precautions and exercised due diligence to avoid the commission of an offence by himself or any person under his control. Moreover, a "manager" is a senior executive who is "principally responsible" for the conduct of an affair or business of an AI. He is therefore expected to exercise proper oversight of the persons under his control. It should also be pointed out that the imposition of strict liability on the directors, chief executives and managers of AIs is aimed at promoting greater vigilance to comply with the BO.

23. With regard to the wording of the new section 2(18), it was suggested that the words "or contributed to" are too wide, in that they could

cover almost anything, which does not necessarily involve culpable behaviour. It was suggested that these words be deleted or at least be qualified to make it clear that the contribution has to be in “a material respect”.

24. On this point, the HKMA would make the point that the words “contributed to” mean that the act or omission of the manager or the relevant person under his control helped to cause or bring about the contravention. The involvement of the manager or the relevant person in the contravention must be causative. Moreover, “contributed to” already includes an element of materiality. This being the case, the HKMA does not consider any change to the current formulation is necessary.

Publication of disciplinary action in respect of relevant individuals

25. To maintain a level playing field between AIs and SFC regulated persons, clauses 9 and 13 of the Bill amend sections 58A and 71C respectively to put it beyond doubt that the MA may disclose to the public certain details of his disciplinary action taken against a relevant individual or executive officer who is engaged in securities business on behalf of an AI, in a manner similar to that followed by the SFC.

26. It was commented that the MA’s decision to suspend the relevant individual (RI) from the register seems to be less serious and should not be published until such time as the final removal from the register occurs. The HKMA considers that the decision to suspend a RI’s particulars from the register and the decision to remove the RI’s particulars from the register are both important disciplinary decisions. At present, the SFC may publish its decisions relating to both revocation and suspension of a licence of a regulated person. To be consistent with this, the MA should have the power to publish both kinds of disciplinary decisions.

27. Under the proposed section 58A(4A) of the Bill, the information which the MA may disclose comprises the reasons for the decision and any further information surrounding the matter. It was suggested that the wording “and any further information surrounding the matter” is too broad and vague and should be deleted. The decision and the reasons for the decision should be adequate.

28. In practice, the MA should publish his decisions made under sections 58A (or 71C) and the reasons for making such decisions. In addition, the MA may also need to publish other information such as the background details of the case. Thus the MA should be provided with the flexibility to publish any other information relating to the case. In response to this comment, however, the draft Bill has been amended by replacing the phrase “and any further information surrounding the matter” with “and any material facts relating to the case”.

Other comments

29. The respondents also made a number of minor drafting comments, which the HKMA has taken into account in finalising the Bill. There were also some other comments or suggestions on the details of the Capital Rules and Disclosure Rules to be made by the MA and the monitoring of compliance with the Disclosure Rules. These comments will be addressed in developing the rules or the related supervisory guidelines.

30. The key points raised by respondents and the HKMA's proposed responses as set out above were discussed at the Basel II Consultation Group Meeting held on 21 January 2004. The members did not make any further comments on the Bill, or disagree with any of the HKMA's proposed responses.

Way forward

31. Consequently, we have amended the consultation draft of the Bill taking into account the responses we have received. The Bill, after being finalised and subject to the Executive Council's approval, will be introduced into the Legislative Council in April 2005.

Hong Kong Monetary Authority
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