# Consultation Paper

# Implementation of Basel III disclosure standards in Hong Kong (D1) (Definition of Capital)

## Purpose

1. This paper sets out, for comment by the banking industry, the HKMA's proposals for the implementation of the Pillar 3 disclosure requirements associated with those of the Basel III capital standards which will come into effect in Hong Kong from 1 January 2013. The paper describes, in this regard, the proposed amendments that the HKMA intends to make to the Banking (Disclosure) Rules ("BDR").

## Overview

2. To improve the transparency of regulatory capital and enhance market discipline, the Basel Committee on Banking Supervision (BCBS) included a commitment in its paper *Basel III: A global regulatory framework for more resilient banks and banking systems*[1] ("Basel III text") to issue more detailed Pillar 3 disclosure requirements in 2011. Thereafter, for this purpose, the BCBS issued a consultation paper on *Definition of capital disclosure requirements*[2] in December 2011, followed in June 2012 by the publication of the final standards on the *Composition of capital disclosure requirements*[3] ("BCBS disclosure text").

3. The BCBS disclosure text sets out detailed standards in relation to the broad areas of disclosure identified in the Basel III text, covering:

   (a) a detailed breakdown of regulatory capital elements (including all regulatory adjustments and the phase-in of these adjustments);

   (b) a reconciliation of all regulatory capital elements back to a bank's financial statements to help explain: (i) any differences in the scope of consolidation for accounting purposes and for regulatory purposes, and (ii) the relationship between balance sheet items and regulatory capital elements;

   (c) a description of all limits and minima, identifying the positive and

[1] This paper can be accessed at the BIS website at http://www.bis.org/publ/bcbs189_dec2010.pdf

[2] This paper can be accessed at the BIS website at http://www.bis.org/publ/bcbs212.pdf

[3] This paper can be accessed at the BIS website at http://www.bis.org/publ/bcbs221.pdf

negative elements of capital to which the limits and minima apply[4];

(d) a description of the main features of the regulatory capital instruments a bank has issued;

(e) an explanation of how any non-regulatory ratios disclosed by banks, that involve components of regulatory capital (e.g. "Equity Tier 1", "Core Tier 1" or "Tangible Common Equity" ratios) are calculated;

(f) the full terms and conditions of all instruments included in regulatory capital (to be made available by banks on their websites); and

(g) specific components of capital, including regulatory capital instruments and regulatory adjustments, that benefit from the transitional arrangements during the transition phase.

4. To enhance the consistency and comparability of the disclosures made by banks in respect of their capital base, the BCBS disclosure text provides common disclosure templates[5] for items (a), (b), (c), (d) and (g) in paragraph 3 above, and prescribes certain minimum standards in respect of item (f).

5. The HKMA intends to adopt fully the standards set out in the BCBS disclosure text. Authorized institutions ("AIs") are therefore encouraged to study the BCBS disclosure text carefully to facilitate their understanding of the new disclosure requirements to be incorporated into the BDR.

6. The BCBS has specified in the BCBS disclosure text that jurisdictions should give effect to the new disclosure requirements by no later than 30 June 2013. The HKMA intends to follow this timeline. Accordingly, whilst AIs will be required to calculate their regulatory capital requirements according to the new Basel III definitions with effect from 1 January 2013, the first set of Pillar 3 disclosures that will be subject to the

---

[4] Disclosure should cover:
- CET1 ratio, Tier 1 capital ratio and Total capital ratio against the Basel minima;
- Details of CET1 capital which is not available to meet buffer capital requirements because it is already used to meet other minima (e.g. a bank with 8% CET1 but no Additional Tier 1 or Tier 2 capital cannot claim that it has a 3.5% buffer above the CET1 minimum);
- Details of how close various items of capital are to the relevant threshold limits available under the deduction framework, covering non-significant capital investments and significant investments in the common shares of banking, financial and insurance entities that are outside the scope of regulatory consolidation;
- Levels of limits on surplus provisions included in Tier 2 capital (which exceed expected losses under the IRB approach).

[5] The BCBS disclosure text contains a set of common disclosure templates covering the transition phase for regulatory adjustments (2013-2018), as well as the period post 1 January 2018, together with a template for the disclosure of the main features of regulatory capital instruments.

new disclosure requirements will be those in relation to a balance sheet date on or after 30 June 2013. For the majority of AIs, whose financial year ends on 31 December, this will mean that the new disclosure requirements will kick-in in respect of their interim financial disclosure in 2013.

7. As the first in a series of consultation papers on the proposed disclosure standards under Basel III, this paper (D1), as noted above, covers disclosure requirements corresponding to those of the Basel III capital standards that are scheduled to take effect from 1 January 2013. Accordingly, this paper covers principally disclosure regarding the definition of capital (including the new minimum capital requirements) as well as disclosure relating to the risk-weighting framework for counterparty credit risk ("CCR") exposures (these areas were the subject of the HKMA's first consultation paper on **Implementation of Basel III capital standards in Hong Kong** (C1) released in January 2012). The HKMA will consult the industry on its proposals for the implementation of the Basel III disclosure requirements associated with other aspects of the Basel III framework separately, in due course, as and when these requirements are issued by the BCBS.

## Approach to implementation

8. The disclosure framework under Pillar 3 of the Basel capital framework is currently set out in the BDR. The BDR are rules made by the HKMA under the Banking Ordinance and are supplemented by supervisory guidance in the Supervisory Policy Manual ("SPM") module on "Guideline on the application of the Banking (Disclosure) Rules" (CA-D-1). For the purpose of implementing the new Basel III disclosure requirements, the HKMA has identified a number of areas where additions/revisions to the BDR are required.

Disclosure relating to definition of capital

9. The HKMA proposes to amend (i) sections 2 and 32 of the BDR to incorporate the new definitions required to accommodate the three new Basel III risk weighted minimum capital ratios and the new constituent elements of the capital base, (ii) sections 5, 11, 15 and 105 where changes are required to align with the Banking (Amendment) Ordinance 2012, and (iii) sections 40, 57, 60, 63, 69, 82 and 85 where changes in the capital treatment of certain items under Basel III necessitates corresponding changes in disclosures.

10. The HKMA also proposes to amend sections 18 and 24 (for interim disclosures) and sections 33 and 45 (for annual disclosures) of the BDR to

reflect the requirements set out in paragraph 3 above. The proposed amendments allow for the HKMA to specify the manner of making the required disclosure. For this purpose, the HKMA would propose to issue disclosure templates for use in Hong Kong (tracking the templates in the BCBS disclosure text referred to in paragraph 4 above), together with corresponding completion instructions later in the year. The HKMA will consider the need to issue supplemental guidance on the use and operation of the local templates, in the light of industry requests and operational experience.

National discretion relating to use of common disclosure templates

11. In general, to ensure the comparability of disclosures by banks across jurisdictions, no adjustments should be made to the common disclosure templates set out in the BCBS disclosure text. Paragraph 41 of the BCBS disclosure text, however, specifies a limited number of exceptions to, or refinements upon, this restriction, including a choice of approach in those cases where the local implementation of Basel III applies a more conservative definition of an element listed in the template. In these circumstances, jurisdictions may choose:

*Approach 1: in the national version of the template to maintain the same definitions of all rows as set out in the common template, and require banks to report the impact of the more conservative national definition in the designated rows for national specific adjustments.*

*Approach 2: in the national version of the template to use the definitions of elements as implemented in that jurisdiction, clearly labelling them as being different from the Basel III minimum definition, and require banks to separately disclose the impact of each of these different definitions in the notes to the template.*

12. As the industry will be aware from the earlier discussions between the industry and the HKMA with regard to consultation paper C1, the HKMA's proposed treatment, for regulatory capital calculation purposes, of unrealized fair value gains on property revaluation, together with deferred tax assets and mortgage servicing rights, can be regarded as more conservative than Basel III. Thus there is a need to decide which of the above approaches to adopt in Hong Kong. Adjustments that are peculiar to local circumstances and not linked to any regulatory adjustments under Basel III (e.g. in the case of Hong Kong, the proposed "anti-avoidance provision" for credit exposures to connected companies), are required to be reported in the designated rows of the common disclosure templates irrespective of the Approach adopted.

13. The HKMA would propose to adopt Approach 2 as it appears more logical for AIs' local disclosure templates to reflect primarily their regulatory capital calculated in accordance with the regulations actually applicable to them in Hong Kong and to use notes to the template to indicate the differences from Basel III.

14. If Approach 1 were to be adopted, the effect would be to require AIs to disclose primarily against Basel III, albeit that their actual regulatory capital requirement in Hong Kong may be different, due to the more conservative approach described in paragraph 12 above. The HKMA is inclined to consider this potentially confusing and hence is minded to adopt Approach 2. The adoption of Approach 2 would not, however, prevent AIs from making additional disclosure, based on Approach 1 (alongside required disclosures using Approach 2) if they see benefits in so doing.

15. The HKMA would specifically welcome the industry's views on this choice of Approach.

Disclosure relating to internal model approach to Counterparty Credit Risk ("IMM(CCR)")

16. As noted in the January 2012 consultative paper (C1), the HKMA proposes to make the IMM(CCR) available in Hong Kong from 1 January 2013. Hence there is a need to incorporate into the BDR appropriate disclosure requirements applicable to banks using the IMM(CCR). In this regard, the HKMA proposes to incorporate additional provisions under section 58 (for AIs which are users of the STC Approach) and section 80 (for AIs which are users of the IRB Approach) of the BDR to reflect the disclosure requirements set out in Table 8 (General disclosure for exposures related to counterparty credit risk) of the Basel II document[6]. The Table sets out the specific Pillar 3 disclosure requirements for banks using the internal model method to calculate their capital requirements for their counterparty credit risk exposures.

Other

17. In the course of amending the BDR, the HKMA is also proposing to take the opportunity to enhance the "Corporate Governance" disclosure requirement under section 52 of the BDR by including disclosure regarding the extent of compliance with Part 3 ("Disclosure on remuneration") of the SPM module on "Guideline on a Sound

[6] This refers to the *International Convergence of Capital Measurement and Capital Standards – A Revised Framework Comprehensive Version* issued by the Basel Committee on Banking Supervision in June 2006. The paper can be accessed at http://www.bis.org/pub/bcbs128.pdf?noframes=1.

Remuneration System" (CG-5). In determining the extent of disclosure, AIs should make reference to the circular letter issued by the HKMA on 23 November 2011 ("Disclosure on remuneration") which highlights certain additional disclosure requirements contained in the *Pillar 3 disclosure requirements for remuneration*[7] issued by the BCBS in July 2011. As mentioned in the circular letter, it is the HKMA's intention to amend CG-5, in due course, to bring it into line with the BCBS Pillar 3 remuneration disclosure standards in a manner suitable for the local banking sector.

18. As with the existing framework, it is proposed that the revised Pillar 3 disclosure framework should apply to all AIs incorporated in Hong Kong, except for those AIs which meet the relevant exemption criteria specified in Part 1 of the BDR.

19. Enclosed in the Annex to this Consultation Paper is a preliminary draft of a set of Banking (Disclosure) (Amendment) Rules prepared by the HKMA to illustrate the amendments to the BDR proposed in this paper. It should be noted that the enclosed draft is subject to change and is provided as a reference only to assist the industry in responding to this consultation. A further draft of the text of the Amendment Rules will be released to the industry under the statutory consultation process required pursuant to the Banking Ordinance. This is expected to be undertaken during the third quarter of this year.

[7] This paper can be accessed at the BIS website at http://www.bis.org/publ/bcbs197.pdf