Press release

LCQ1: Volcker Rule

Wednesday, May 9, 2012

Following is a question by Dr Hon David Li and a reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (May 9):

Question:

I have learnt that financial regulators from around the world have raised concerns about the extra-territorial impact of the proposed regulations for implementation the Volcker Rule (proposed regulations) in the United States (US). Specifically, concerns have been expressed about the implications for non-US banks operating a subsidiary in US, the special exemptions offered to US government securities but not to the securities of other governments, the restrictions US banks will face in participating in foreign exchange swap markets overseas and the controls to be imposed on trades involving US-domiciled counterparties. In this connection, will the Government inform this Council:

(a) of the impact of the proposed regulations on Hong Kong's position as an international financial centre when they are implemented as originally proposed;

(b) what steps the Government has taken and continues to take to convince the US Government to amend and relax the proposed regulations; and

(c) whether the Government has any contingency plan to cope with the impact of the proposed regulations when they are implemented in their current form; if it has, of the details?

Reply:

President,

To give Members some perspective, the United States enacted in July 2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), with a view to, among other purposes, "promoting the financial stability of the US by improving accountability and transparency in the financial system".

The "Volcker Rule", as commonly referred to by the markets, is embodied in section 619 of the Dodd-Frank Act. As we understand it, the Rule aims to prohibit US banks, their affiliates and holding companies from engaging in two types of business activities, namely, first, proprietary trading, and second, investing in and sponsoring hedge funds and private equity funds.

While this Volcker Rule is entirely a US regulation, it appears to seek to apply to the worldwide operations of non-US banks that have an agent, branch, or subsidiary in the US. In this light, the implementation of the Rule in its current form appears to entail an extra-territorial reach, thus affecting financial markets outside of the US.

Accordingly, Hong Kong shares the concerns raised by major financial markets, such as Canada, France, Germany, Japan and the United Kingdom, over the extra-territorial reach and the implementation of the Rule.

In this connection, the Administration's reply to the three parts of the question is as follows -

(a) Hong Kong is concerned that the Volcker Rule may bring about the following unintended repercussions -

(i) non-US banks that are caught by the Rule may face a substantial compliance burden, as they will have to comply with the onerous record-keeping and reporting requirements imposed by the Rule, if their trading assets and liabilities are higher than USD 1 billion on a global consolidated basis;

(ii) the Rule may adversely affect the liquidity in non-US government bond markets, as it only permits regulated banking entities to engage in proprietary trading in US government securities but not foreign government securities;

(iii) it may adversely affect banks' ability to manage funding through the foreign exchange swap market, which is an important interbank funding channel, given that foreign exchange swaps are classified as derivatives hence subject to the prohibition in connection with proprietary trading; and

(iv) it may also affect fund raising activities of hedge funds and private equity funds, because banks subject to the Rule will have to refrain from sponsoring and investing in some of these funds. This in turn may negatively affect the fund management and asset management operations of banks.

(b) Given the concerns as highlighted above, the Financial Secretary has written to the US Department of Treasury earlier this year to indicate the unintended adverse consequences that we see in relation to the application of the Volcker Rule. He has specifically invited the US authorities to consider ring-fencing the application of the rule and maximising the exemption, insofar as it relates to banking operations outside of the US, as well as proprietary trading in respect of non-US government securities and short term foreign exchange swaps.

I have also followed this up during my duty visit to the US in March. To this end, I have discussed this subject with senior officials in the US Department of Treasury, Securities and Exchange Commission, Commodity Futures Trading Commission, International Monetary Fund, and other relevant interlocutors and stakeholders, in order to reflect the concerns expressed by the financial industry in Hong Kong.

In addition, the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) have engaged market participants and shared their readout with their regulator counterparts in other international financial centres, in order to generate a regional voice as regards our collective concerns.

(c) As far as we understand, the original timetable for the implementation of the Volcker Rule was set for July 21 this year. That said, the US authorities have yet to finalise the implementation detail of the Rule. In addition, we note that the Chair of the Board of Governors of the US Federal Reserve System has mentioned to the Congress that relevant parties are unlikely to meet the July deadline to complete work on the Volcker Rule. Accordingly, and in response to the comments received, the US Federal Reserve Board clarified last month that any entity covered by the Volcker Rule will be entitled to a two-year period starting from July 21, 2012 to "conform their activities and investments with the prohibitions and restrictions" under the Rule, unless that period is further extended by the Board.

It appears to us that discussions are still underway in the US as to how the Volcker Rule will be implemented. To this end, the Administration, together with HKMA and SFC, will continue to monitor closely the ongoing developments, and to take every suitable opportunity to reiterate our concerns. We will also work together with the financial industry in Hong Kong, including Hong Kong Association of Banks and the Treasury Markets Association, on any necessary measures or responses in view of the future developments in this respect.

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