Briefing to the Legislative Council Panel on Financial Affairs

on

Implementation of the New Capital Accord ("Basel II") in Hong Kong

Hong Kong Monetary Authority
5 July 2004

Scope of Today's Presentation

- Brief introduction on capital standard set by the Basel Committee
  - Existing capital adequacy framework ("Basel I")
  - New Basel Capital Accord ("Basel II")
- Application of Basel II in Hong Kong
- HKMA's proposed implementation plan
- Concluding remarks

Existing Capital Adequacy Framework
(“Basel I”)

Existing Capital Adequacy Framework ("Basel I")

- The international standards in the field of banking supervision are set by the Basel Committee on Banking Supervision, a G10-established Committee comprising 13 members from Europe, North America & Japan. Hong Kong is not a member of the Committee, but together with around 100 other supervisors worldwide adopts the standards set by the Committee.

- A key element of the Basel supervisory approach is the capital adequacy ratio (CAR) adopted in 1988 ("Basel I"). Capital is important because it provides a buffer against losses, i.e. it provides some assurance that a bank will remain solvent even if it incurs losses. In the case of a bank being wound-up, the capital should ideally be sufficient to ensure that creditors (primarily depositors) can be paid off from the proceeds, without any charge to the public purse

- Adopted by Hong Kong through legislation under the Third Schedule to the Banking Ordinance

Existing Capital Adequacy Framework ("Basel I")

- Capital held by banks - a buffer that helps to absorb losses and thus protect depositors
- Banks are required to maintain capital against credit risk - measured by the capital adequacy ratio ("CAR")
- CAR = $\dfrac{\text{capital base}}{\text{risk weighted assets}}$
- Risk weighted assets = each class of asset claims x risk weights (0%, 20%, 50%, 100%)
- Minimum CAR under Basel I is 8%

Existing Capital Adequacy Framework ("Basel I")

- Basel I has enhanced capital adequacy of banks and fostered competitive equality
- However, it has become outdated as the financial world has evolved significantly since 1988
- Limitations of the current framework:
  - risk weightings are too broad-brush and insufficiently "risk-sensitive"
  - many other risks run by banks (e.g. operational risk and interest rate risk in the banking book) are not reflected in the CAR
  - it does not provide the proper incentives for risk mitigation techniques

The New Basel Capital Accord
(“Basel II”)

The New Basel Capital Accord ("Basel II")

- An attempt of the Basel Committee to address shortcomings of Basel I and further two additional objectives:
  - provide an impetus to and incentives for enhanced risk management
  - promote market discipline by means of improved disclosure
- More than a reworking of calculation under Basel I - a major step forward in terms of identification, quantification and management of risk
- Widespread support by countries with internationally-active banks - non-G10 countries such as Australia and Singapore are planning to adopt Basel II according to the Basel timetable while others in the region are considering implementation at a later stage

The New Basel Capital Accord ("Basel II")

- Basel II has a 3-pillar structure: Pillar 1 is essentially an upgrade of the Basel I CAR, but extended to cover operational risk as well as credit & market risks; Pillar 2 covers other risks, e.g. reputational risk, business cycle risk, interest rate risk in the banking book; & Pillar 3 covers disclosure.

New Accord

- Pillar 1
  Minimum Capital Requirements
  - Credit risk
  - Operational risk*
  - Market risk
- Pillar 2
  Supervisory Review Process
  - Interest rate risk in banking book*
  - Other risks*
- Pillar 3
  Market Discipline (Disclosure)

The New Basel Capital Accord ("Basel II")

- Menu of approaches to measure risk under Pillar 1:
  - Credit risk
    - Standardised Approach
    - Internal Ratings-Based (IRB) Approach
      - Foundation IRB Approach
      - Advanced IRB Approach
  - Operational risk
    - Basic Indicator Approach
    - Standardised Approach
    - Advanced Measurement Approaches (AMA)
  - Market risk
    - Standardised Approach
    - Internal Models Approach
- The choice of approaches is left up to individual banks, subject to our being satisfied that their choices are appropriate given the nature and scale of their activities

The New Basel Capital Accord ("Basel II")

- Basel II is considerably more risk-sensitive than Basel I. Perhaps most notable is the change in the treatment of credit risk. Banks will have several options. Those banks which have sophisticated internal ratings models to quantify their credit risk will be able to use these systems to calculate their capital requirement for credit risk. This is known as the internal ratings based, or IRB, approach, & there are 2 variants, the foundation & advanced approach. Capital charges will be assessed against a borrower's probability of default (PD), taking into account the facility's loss given default (LGD).

The New Basel Capital Accord ("Basel II")

- Other banks will use the standardised approach, superficially similar to the current system, but with the important difference that the risk weights will be linked to external ratings & various risk mitigation techniques. There will be preferential weightings for residential mortgage & retail lending.

- Similarly, methods of varying sophistication will be available in respect of operational risk - the basic indicator, standardised, & advanced measurement (AMA) approaches.

The New Basel Capital Accord
("Basel II")

- With a range of approaches and options to suit banks of varying sophistication, Basel II represents a move away from the "one size fits all" approach

- This seems the best way of accommodating the diversity of banks in Hong Kong - large and small, local and foreign, retail and wholesale

Application of Basel II in Hong Kong

Application of Basel II in Hong Kong

- As a major IFC it is natural for Hong Kong to implement Basel II at the same time as the Basel Committee members
- Greater risk sensitivity of Basel II and inclusion of wide range of risks will further enhance safety and stability of the banking sector
- Implementation will enhance reputation and international standing of Hong Kong
- Banks' investment in the implementation of Basel II is not an unnecessary compliance cost but a necessary business investment in improved risk management

Application of Basel II in Hong Kong

- The HKMA has engaged in extensive consultation over the last several years (including discussion with a recently formed “Basel II Consultation Group” consisting of industry representatives, accounting representatives and other interested parties)

- The industry is supportive of our proposed approach to implementation

Application of Basel II in Hong Kong

- The process of implementation is being market driven - primarily by major international banks, but with local banks also now more engaged in the process
- Major international banking groups with presence in Hong Kong will implement Basel II, globally in 2006
- Indigenous local banks also recognise the business need to implement Basel II, given the benefit of increased risk management and disclosure
- We are prepared to allow for a more simplified approach alongside with Basel II as it may not be justified on a cost-benefit basis for very small institutions (mostly restricted licence banks and deposit-taking companies) to adopt Basel II in full

HKMA's Proposed Implementation Plan

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- Detailed work plan has been developed
- Tie in with the implementation date of the Basel Committee
- A menu approach will be adopted
- On-going consultation with the industry will continue
- Legislating Basel II a key and challenging issue in the implementation process
- Given that the method of calculating CAR under Basel II will be considerably more complex, substantive legislative changes to the Banking Ordinance (including the Third Schedule) are expected
- The HKMA is considering possible legislative approaches and aiming at submitting a Banking Amendment Bill during the 2004/05 legislative year. We will keep the Panel updated when there are more concrete proposals on legislative changes

Concluding Remarks

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- While implementation challenges for banks and the HKMA are not inconsiderable, good progress is being made
- Positive for Hong Kong as one of the first non-Basel jurisdictions to implement Basel II
- Reinforcing that we are on a par with the world's top international financial centres
- Although carries significant implementation costs, many benefits anticipated:
  - enhancement of safety and stability of banking sector
  - enhancement of reputation of banking sector and supervisory system
  - enhancement of banking sector's ability to take on and manage risk, crucial to their role of financing growth in the economy

Comments and Questions