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Briefing to the Legislative Council Panel on Financial Affairs

Basel II and Proposed Legislative Amendments to the Banking Ordinance

Hong Kong Monetary Authority
6 December 2004



Scope of Today's Presentation

- Discussion of the background to, and main concepts underlying, the framework for international capital adequacy standards - Basel I and Basel II.
- Progress of the preparations for implementing Basel II in Hong Kong since the last briefing to the Panel in July 2004.
- Proposed amendments to the Banking Ordinance to put the Basel II requirements into legislation.

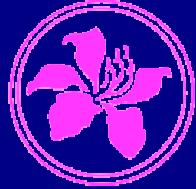


Existing Capital Adequacy Framework (Basel I)



Basel I

- The international standards in the field of banking supervision are set by the Basel Committee on Banking Supervision (BCBS), 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.
- Basel I was adopted by Hong Kong through legislation under the Third Schedule to the BO.
- Adopting international standards such as Basel I has played an important role in establishing Hong Kong as an international financial centre with best practice regulation and supervision



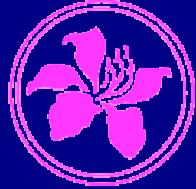
Basel I

- A key element of the Basel supervisory approach is the capital adequacy ratio (CAR).
- 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.
- The strength of the capital ratio is generally regarded as the best single indicator of a bank's (or banking system's) strength, and is therefore important for public/investor confidence.



Basel I

- Banks are required to maintain capital against credit risk - measured by the capital adequacy ratio (CAR)
- $$\text{CAR} = \frac{\text{capital base}}{\text{risk weighted assets}}$$
- Risk weighted assets = each class of asset claims
$$\times$$
 risk weights (0%, 20%, 50%, 100%)
- Minimum CAR under Basel I is 8%
- Average CAR of all locally incorporated authorized institutions (AIs) is currently around 16%



Basel I

- Basel I has improved capital adequacy of banks globally and fostered competitive equality.
- However, recent technological advancement, innovations in financial products and further globalisation have underscored the 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 incentives for risk mitigation techniques



The New Basel Capital Accord (Basel II)



Basel II

Basel II is :

- An attempt by the BCBS to address shortcomings of Basel I and further two additional objectives:
 - provide banks an impetus to and incentive for enhanced risk measurement and management; and
 - promote market discipline by means of improved disclosure.
- A major step forward in terms of the identification, quantification and management of risk.
- Widely supported by countries with internationally-active banks and most significant non-G10 countries (e.g. Australia and Singapore) will adopt Basel II in full.

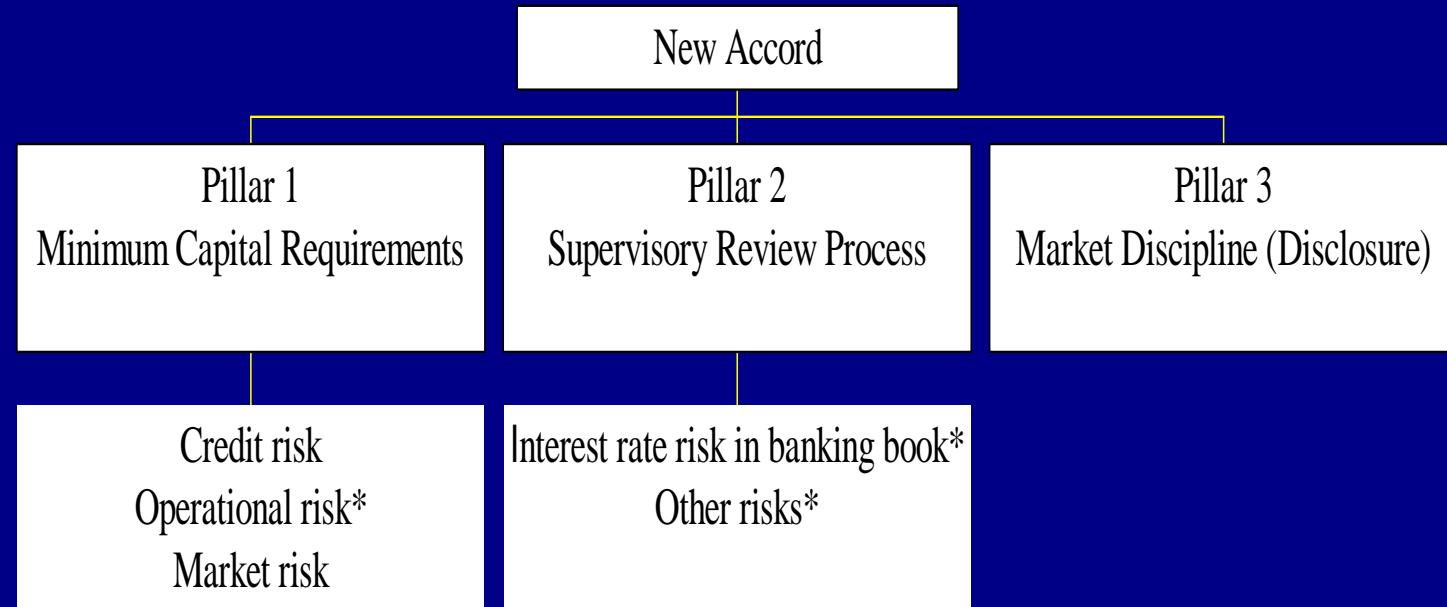


Basel II Framework

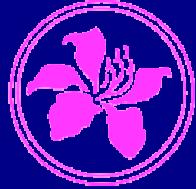
- Basel II has a 3-pillar structure:
 - Pillar 1 is essentially an upgrade of the Basel I CAR that captures credit & market risks, but extended to operational risk;
 - Pillar 2 focuses on the supervisory review process of banks and requires banks to have in place sound internal processes to assess their capital adequacy against risks including reputational risk and interest rate risk in the banking book which are not covered in Pillar 1; and
 - Pillar 3 covers market discipline through public disclosure of bank's key information on capital, risk exposures and risk assessment.



Basel II Framework



* new risks covered under Basel II



Approaches to Measuring Risks

- 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 IRB Approach

- Under Basel II, banks will have several options to measure their credit risk.
- 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, and 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).



Other Measurement Approaches

- 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.



Basel II Implementation Timetable

- Basel II is considerably more risk-sensitive than Basel I, notably in the treatment of credit risk.
- With a range of approaches and options to suit banks of varying sophistication, Basel II provides an effective means of accommodating the diversity of banks in Hong Kong - large and small, local and foreign, retail and wholesale. [However, we plan to also offer an additional Basic approach for smaller AIs, in response to industry suggestions.]
- BCBS has proposed implementation of the Standardised and Foundation IRB Approaches from year-end 2006, and the most advanced approaches for credit risk and operational risk from year-end 2007.



Major Benefits of Implementation

- Will promote the adoption of stronger risk management practices by the banking industry, which will help enhance the safety and stability of the local banking sector.
- Improved risk management will enhance the banking sector's ability to offer to customers, and use internally, more sophisticated products such as derivatives; will increase banks' ability to assess lending to sectors such as SMEs; and will allow for better risk-adjusted pricing, with lower rates for better customers
- Implementation will enhance the reputation and international standing of Hong Kong as an international financial centre.
- Banks' investment in the implementation of Basel II is a necessary business cost, not an unnecessary compliance cost. The cost for banks will be determined by which approaches they decide to adopt.



Progress in Preparing for Basel II in Hong Kong



Ongoing, Extensive Market Consultation (1)

- Extensive consultation is ongoing, including
 - the HKMA's Basel II Consultation Group, which includes representatives from the industry and other interested parties;
 - the Banking Advisory Committee & Deposit-taking Companies Advisory Committee; and
 - the industry and the public through issuing a detailed consultation package on our implementation proposals and an addendum in August and September
- Meetings have also been held with individual banks regarding their implementation timetable for adopting the IRB approach.



Ongoing, Extensive Market Consultation (2)

- The consultative proposals issued by the HKMA have covered, among other things:
 - Technical requirements on key areas of Basel II;
 - The rule-making approach it is proposed the HKMA should adopt in putting the revised capital adequacy framework into legislation ; and
 - The need for extending the current capital adequacy regime to holding companies of AIs.
- Parties consulted welcomed and endorsed the proposals as a pragmatic means of implementing Basel II in Hong Kong. Comments received were mostly to seek clarification on technical issues.



Proposed Implementation Approach for Hong Kong

- Propose implementation of Basel II in Hong Kong by end-2006 to tie in with BCBS timetable.
- All approaches set out in Basel II, except the AMA for operational risk, which is still evolving, will be adopted.
- A new Basic Approach (essentially a modified version of Basel I with slight definitional changes and incorporation of an operational risk capital charge and Pillars 2 & 3 under Basel II) will be made available to AIs with small, simple and straightforward operations to address industry concerns about costs and complexity of implementation.
- The choice of approaches is left to individual AIs, subject to the MA being satisfied that AIs' choices are appropriate given the nature and scale of their activities.



Legislative Amendments to Implement Basel II



Justifications for Legislative Amendments

- Current legislative framework for Basel I embodied in Part XVII and Third Schedule of the Banking Ordinance (BO).
- Basel II involves a significantly more sophisticated approach to the calculation of CAR and extends its scope to bank holding companies (BHCs), hence the need to amend the BO for implementing Basel II in Hong Kong.
- Proposed amendments to the BO involve 3 major areas:
 - capital adequacy ratio of AIs;
 - enhancement of the existing financial disclosure regime applicable to AIs; and
 - imposition and policing of capital and disclosure requirements in respect of BHCs.



Designation of BHCs

- Basel II is designed to apply also to BHCs so as to ensure that the risk that the whole banking group poses to an AI is captured in the risk assessment process. The aim is to achieve consolidated supervision.
- A controller will not be designated if it is an AI incorporated in Hong Kong or if it is incorporated outside Hong Kong and is subject to adequate supervision.
- The MA already has powers (s.70 of BO) to impose conditions on controllers of AIs, but the proposed capital and disclosure requirements in respect of BHCs are more formal and transparent.
- It is expected that only a handful of controllers would be designated as BHCs.



MA's Power to Make Capital & Disclosure Rules

It is proposed that the BO be amended to provide the MA with the power to promulgate Capital Rules and Disclosure Rules for the introduction of the revised capital framework. This is necessary given:

- The impracticality of putting the complex requirements of Basel II into legislation through the existing approach
- The ongoing need to keep the regime up to date in light of industry developments and evolving international practices



Contents of Capital Rules & Disclosure Rules

Capital Rules

- Prescribe individual components of the capital base and the manner in which credit, market and operational risks are to be taken into account in calculating the CARs of AIs and BHCs.

Disclosure Rules

- Prescribe information to be disclosed to the general public by AIs and BHCs in relation to their state of affairs, profit and loss, and capital adequacy, as well as the frequency for disclosing such information as an extension of s60A of the BO on public disclosure of information.



Operation of the Rule Making Approach

- The power sought is strictly confined to making Rules necessary for implementing Basel II – and is consistent with the MA's existing functions under s7 (i.e. no extension of the scope of the MA's functions is involved).
- The Rules will have the status of subsidiary legislation, and hence will be subject to negative vetting by LegCo.
- The MA may issue guidelines to provide guidance on the exercise of his powers under the Rules.
- The approach is similar to that under the Securities and Futures Ordinance and the Deposit Protection Scheme Ordinance.



Check and Balance Measures

- It is already the established practice of the MA to consult widely and extensively.
- To reinforce this, however, the MA will be obliged consult the Banking Advisory Committee and DTC Advisory Committee, the industry associations and the Financial Secretary before issuing the Rules (and will also consult other parties as appropriate).
- The MA will be obliged to review any decision made under the Rules which aggrieves the party concerned.
- In addition, there will be a formal right of appeal to CE in Council in respect of certain key decisions.
- And, as mentioned previously, the Rules will be subsidiary legislation and therefore subject to negative vetting.



Maximum CAR for AIs

- Currently, the MA is empowered to set the minimum CAR for individual banks in the range of 8-12%, and for individual RLBs and DTCs in the range of 8-16%.
- In practice, the minimum CAR for individual banks has been set in the range of 10-12%. This is a very narrow range, and means that the MA's ability to set higher minimums when the circumstances require – for example, if there is a major upwards shift in the risk profile of individual banks, or of the industry as a whole - is limited.
- In the MA's view, therefore, it is desirable to extend the upper end of the range for banks to 16% [N.B. most other regulators have no upper limit].
- There is no current intention, however, based on current circumstances, to increase the minimum for any individual bank.
- Preliminary industry consultation has indicated no objection to this proposal.



Review of Offence Provisions and other Amendments

Vicarious liability of managers

Propose to amend s.2 of the BO so that the vicarious liability of managers of an AI is limited to circumstances where the contravention was caused or contributed to by the manager himself, or by a person under his control.

Publication of disciplinary action in respect of AIs' securities business

Propose to amend s.58A and s.71C of the BO to put it beyond doubt that the MA may publish his disciplinary actions against relevant individuals and executive officers of AIs in a manner followed by the SFC.



Concluding Remarks

- Hong Kong was one of the first jurisdictions globally to publish draft implementation guidelines for Basel II, thereby giving our banks a head-start.
- Other regulators have since followed our lead, and are adopting similar approaches. Hong Kong's leadership in this area is widely acknowledged.
- The HKMA will continue to work closely with the industry, including the Basel II Consultation Group, with a view to implementing the Basel II framework in a manner tailored to Hong Kong's needs while meeting the international standards required of banks.
- The drafting of the Banking (Amendment) Bill 2005 is expected to be finalised by early December for industry consultation before being introduced into LegCo in Q2 2005.



Questions and Answers