

**Presentation to  
Legislative Council  
Panel on Financial Affairs**

**Progress of Implementation of  
Basel II in Hong Kong**

**Hong Kong Monetary Authority  
4 May 2006**

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**Content of briefing**

- Overall features of Basel II
- Implementation timelines for Hong Kong
- Progress of preparations for implementation
  - Policy setting
  - Development of Rules
  - Consultation and dialogue with Authorized Institutions (AIs)
  - Establishment of Capital Adequacy Review Tribunal (CART)
- Concluding remarks

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**Basel II  
(Three-pillar structure)**

**Pillar 1:** sets out minimum capital requirement for a bank's credit, market and operational risks

**Pillar 2:** deals with other risks not covered under Pillar 1; requires banks to hold capital to cover these risks; and requires supervisors to review banks' capital planning

**Pillar 3:** requires a bank to enhance its public disclosures on its risk profile, capital adequacy and key financial information

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**Scope of implementation in Hong Kong**

- Basel II's three-pillar structure will apply to all AIs incorporated in Hong Kong
- AIs have a choice of approaches for calculation methodologies, depending on their risk profiles and sophistication in risk management
- Smaller AIs can stay on the current framework for credit risk, subject to a few technical adjustments
- MA will continue to set minimum CARs for individual AIs, based on guideline for implementation of Pillar 2 under consultation

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**Implementation timelines for Hong Kong**

2004	2005	2006	2007	2008
Basel II published (Jun)	Additional implementation proposals released (Feb, Oct & Dec)	Drafting of the Rules for : • Preliminary consultation (Jan – Jun) • Statutory consultation (July – Aug) • Gazette (Sep)	Implementation of : • all approaches under Capital Rules except Advanced IRB • Disclosure Rules (Reporting periods beginning 1 Jan)	Availability of Advanced IRB under Capital Rules (Jan)
Implementation proposals on revised capital standards released (Aug & Sep)	Banking (Amendment) Ordinance 2005 enacted (July)	• Tabling in LegCo for negative vetting (Oct)		
Drafting and Consultation of Banking (Amendment) Bill 2005	Drafting of Capital and Disclosure Rules (the Rules)			

← Policy Setting →      ← Rules Development →      ← Implementation →

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**Statutory backing for implementation**

- Banking (Amendment) Ordinance 2005 enacted in July 2005
- Provision of a rule-making power for MA to prescribe rules governing the calculation and disclosure of AIs' CAR
- Two sets of rules - the Capital Rules and Disclosure Rules - will be promulgated in the form of subsidiary legislation
- MA is also empowered to issue guidelines on interpretation and operation of the Rules

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## Policy setting

- Development of implementation proposals has been guided by the Basel II Consultation Group and the comments of the statutory advisory committees, industry associations and other interested parties from the subsequent consultation
- All implementation proposals have been issued to and endorsed by the industry

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## Development of Rules (1)

### Approach

- The HKMA has engaged a consultant draftsman to assist in the production of detailed Drafting Instructions to facilitate the drafting process
- The Rules are developed in 5 batches, given the length and complexity of the Basel II requirements
- The draft Rules are subject to two rounds of consultation : preliminary industry consultation on each batch and statutory consultation on the whole set of Rules

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## Development of Rules (2)

### Statutory consultation

- As required under the Ordinance, the Rules will be tabled in the Legislative Council after consultation with :
  - the Banking Advisory Committee
  - the Deposit-taking Companies Advisory Committee
  - the Hong Kong Association of Banks
  - the DTC Association
  - the Financial Secretary
- The Panel has been provided with the latest drafts of all parts of the Capital Rules, and the policy paper on the Disclosure Rules.

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## Development of Rules (3)

### Content of Capital Rules

- To prescribe the manner in which AIs shall calculate their CAR under section 98 of the Banking Ordinance (BO), based on earlier consulted proposals
- To replace Basel I requirements set out in the Third Schedule to the BO
- Preliminary industry consultation : the first three batches completed, the fourth batch in progress
- The Rules are “technical”, putting flesh on the bones of the primary legislation

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## Development of Rules (4)

Outline of Capital Rules

- Part 1: Preliminary
- Part 2: Application of these Rules
- Part 3: Determination of Capital Base
- Part 4: Calculation of Credit Risk
- Part 5: Calculation of Operational Risk
- Part 6: Calculation of Market Risk
- Part 7: Asset Securitization

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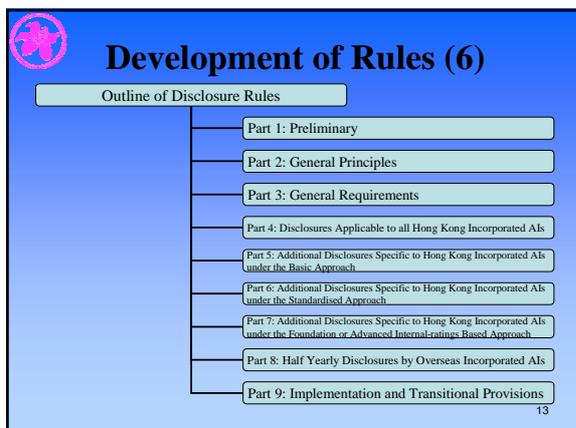


## Development of Rules (5)

### Content of Disclosure Rules

- To prescribe the manner in which AIs shall make public disclosure of information relating to their risk profile, capital adequacy and key financial information
- To replace existing HKMA disclosure guideline for reporting periods beginning 1 Jan 2007 (i.e. from 2007 interim results)
- Preliminary industry consultation : Rules being developed under the guidance of the Working Party on Financial Disclosures and Basel II Consultation Group
- Drafting and statutory consultation are expected to complete in time for introduction to the Legislative Council at the same time as the Capital Rules

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**Dialogue with industry**

- The HKMA has maintained close dialogue with the industry to ensure that
  - the revised framework and implementation approach are tailored to Hong Kong's circumstances while meeting international standards
  - AIs can achieve compliance by 1 January 2007
- Sufficient guidance and time have been made available to AIs to prepare for implementation

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**CART (1)**

- A new appellate body to be established under the BO
- Scope of responsibilities
  - To review major decisions of the MA made under Capital Rules which are specified in the Rules as appealable
- Right of Appeal
  - In respect of fundamental decisions as to which approach to capital adequacy calculation an AI may adopt which may have a material impact on the AI's capital requirement

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**CART (2)**

- The CART may affirm, vary or set aside the MA's decision, or remit the matter to the MA with any direction that it considers appropriate
- The determination of the CART is final and is not subject to appeal, except where a dissatisfied party to the review may appeal to the Court of Appeal against the CART's determination on a point of law

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**CART (3)**

- Establishment
  - A chairman (qualified for appointment as a judge of the High Court) and
  - At least two other members (not being public officers)
  - To be appointed by the Chief Executive
- Commencement of operation
  - Same time as the Capital Rules become effective
- Number of appeals expected to be minimal given HKMA's close dialogue with AIs in their preparation for implementing Basel II (e.g. on their choice of calculation approaches)

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**Concluding remarks**

- The HKMA
  - has adopted an implementation approach which is pragmatic, cost-effective and flexible
  - will continue
    - its preparatory work for implementation by January 2007
    - its dialogue with AIs on their preparations for implementation
- Successful passage of the legislation will facilitate AIs' preparations for implementation by the target date, consistent with Hong Kong's position as an international financial centre

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