For discussion
on 6 December 2004

Legislative Council Panel on Financial Affairs

Briefing on "Basel II" and Proposed Legislative Amendments to the Banking Ordinance

PURPOSE

The purpose of this paper is to –

(a) give the Panel a brief introduction on the international capital adequacy standards for banks - Basel I and Basel II;

(b) report on the progress of the preparation for implementing Basel II in Hong Kong since the last briefing to the Panel in July 2004; and

(c) brief the Panel on the proposed amendments to the Banking Ordinance to put the Basel II requirements into legislation.

THE INTERNATIONAL CAPITAL ADEQUACY STANDARDS FOR BANKS – BASEL I AND BASEL II

Existing Capital Adequacy Framework (Basel I)

2. The international standards in banking supervision are set by the Basel Committee on Banking Supervision (BCBS). A key element of the BCBS' supervisory approach is the capital adequacy ratio (CAR) set out in the Basel Capital Accord adopted in 1988 (widely known as Basel I).[1] Basel I introduced a capital adequacy measure for credit risk, including on and off-balance sheet assets, based on varying risk weights (0%, 20%, 50%, and 100%) assigned to different classes of assets (e.g. central governments and banks of OECD countries, residential mortgages and non-bank private sector). The minimum CAR under Basel I is 8%, calculated by dividing a bank's capital base by its risk-weighted assets. Hong Kong has adopted Basel I and its subsequent amendments through legislation under the Third Schedule to the

[1] The capital held by a bank helps to absorb losses and thus protect its creditors (primarily depositors) in the event that the bank is wound up.

Banking Ordinance (BO) (Cap. 155).[2] Despite the statutory minimum of 8%, the average CAR of all locally incorporated authorized institutions (AIs) is much higher, at 15% - 16%.

3. Basel I has enhanced the capital adequacy of banks globally and fostered competitive equality. That being the case, recent technological advancement, innovations in financial products, and further globalisation have changed the international financial landscape dramatically. This has rendered Basel I too broad-bush and insufficiently "risk-sensitive" to capture many risks that banks face, e.g. operational risk and interest rate risk in the banking book. Moreover, the framework does not provide adequate incentives for banks to apply risk mitigation techniques. Against this backdrop, the BCBS, after development for some five years, published in end-June 2004 a new capital adequacy framework (known as Basel II) to replace Basel I.

New Basel Capital Accord (Basel II)

4. Basel II aims to provide an impetus to, and incentive for, banks to enhance risk measurement and management, and to promote market discipline by means of improved disclosure. More than simply a reworking of the calculation method under Basel I, Basel II is a major step forward in terms of the identification, quantification and management of risk. It has received widespread support from countries with active international banks. In addition to the G-10 countries, many major non-G10 countries, such as Australia and Singapore, are planning to adopt Basel II in full.

5. Basel II is built on a three-pillar structure, of which the salient features are briefly described below.

Pillar 1 – Minimum Capital Requirements

6. Pillar 1 of Basel II sets out the minimum capital requirements. While maintaining the minimum CAR requirement of 8%, the calculation will be extended to cover banks' exposure to operational risk, in addition to the presently covered credit risk and market risk. Different calculation approaches for each type of risk are available for adoption by individual banks.

7. In calculating credit risk, a bank may use the Standardised Approach (superficially similar to the current system but based on ratings assigned to borrowers by external agencies and other risk mitigation techniques), or the Internal Ratings-Based (IRB) Approach, which uses supervisor-validated internal ratings models to quantify risks. Depending on

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[2] Subsequent amendments to the Accord have addressed other issues regarding bank capital. Most importantly, the 1996 Market Risk Amendment set minimum capital requirement for banks' trading positions in bonds, equities, foreign exchange and commodities.

the level of sophistication of the bank's internal rating systems, banks may choose either the Foundation IRB Approach or Advanced IRB Approach. Capital charges will be assessed against a borrower's probability of default (PD), taking into account the facility's loss given default (PGD).

8. While the measurement method for market risk remains unchanged, three measurement approaches, in order of increasing sophistication, are available for banks to choose for quantifying operational risk, namely Basic Indicator Approach, Standardised Approach, and Advanced Measurement Approach (AMA).

Pillar 2 – Supervisory Review Process

9. Pillar 2 focuses on the supervisory review process of a bank and requires that banks should have in place sound internal processes to assess the adequacy of their capital, based on a thorough evaluation of their risks including those risks not covered under Pillar 1, such as interest rate risk in the banking book and reputational risk. Banks are expected to hold capital above the regulatory minimum and supervisors must intervene at an early stage if capital levels became insufficient.

Pillar 3 – Market Discipline

10. Pillar 3 is to complement Pillar 1 and Pillar 2 by encouraging market discipline through public disclosure of key information on capital, risk exposures and risk assessment of a bank.

11. 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.

Implementation Schedule

12. The BCBS has proposed that the implementation schedule for the Standardised Approach and Foundation IRB Approach should be as from year-end 2006, with the most advanced approaches for credit risk and operational risk being implemented at year-end 2007.

Major Benefits of Implementation

13. One of the major benefits of Basel II is to promote the adoption of stronger risk management practices by the banking industry, which would help enhance the safety and stability of the local banking sector. From the banks' and their customers' perspectives, considerable benefits can be derived from improving risk management. It will improve the banking sector's ability

to offer to customers, and use internally, more sophisticated products such as derivatives. It will increase banks' ability to assess lendings to sectors such as small and medium enterprises, and will allow for better risk-adjusted pricing, with lower rates for better customers. Therefore, banks' investment in the implementation of Basel II is more appropriately regarded not as an unnecessary compliance cost, but as a necessary business investment. With Basel II representing best practice international capital measurement and capital standards, implementation of Basel II in Hong Kong will also enhance Hong Kong's reputation as an international financial centre.

PROGRESS OF PREPARATION FOR IMPLEMENTING BASEL II IN HONG KONG

Ongoing, Extensive Market Consultation

14. The Hong Kong Monetary Authority (HKMA) has undertaken extensive public consultation on an ongoing basis in developing the implementation plan on Basel II. Parties consulted include the Basel II Consultation Group,[3] the Banking Advisory Committee (BAC), the Deposit-taking Companies Advisory Committee (DTCAC), The Hong Kong Association of Banks (HKAB) and the DTC Association (DTCA). Specifically, the HKMA has issued to the industry and the public a detailed (350-page) consultation package on implementing Basel II in Hong Kong in August/September 2004. The consultative proposals covered, among other things, technical requirements on key areas of Basel II, the rule-making approach the HKMA proposes to adopt in putting the revised framework into legislation, and the need for extending the current capital adequacy regime to the holding companies of AIs. In sum, the consulted parties endorsed the proposals as a pragmatic means of implementing the revised framework in Hong Kong. The comments received were mostly to seek clarifications on a number of technical issues. The Legislative Council (LegCo) Panel on Financial Affairs was briefed in July 2004 on the major features of Basel II and the HKMA's plan to implement the new capital framework in Hong Kong.

Proposed Implementation Approach for Hong Kong

15. The Administration proposes to implement Basel II in Hong Kong by the end of 2006 to tie in with the timetable of the BCBS. Considering the benefits of Basel II over the existing capital regime, the Administration is keen to ensure that the approaches that we made available will accommodate all locally incorporated AIs, taking into account their risk profile, size and complexity of operations, and the need for those intending to adopt the IRB Approach to concentrate resources on system changes and data validation. To

[3] The Basel II Consultation Group comprises representatives from the HKMA, the industry, the accounting profession, and other interested parties.

this end, the HKMA proposes that in addition to the approaches set out in Basel II (except the AMA for operational risk, which is still evolving), there will be a "Basic Approach" for credit risk under the revised capital framework for Hong Kong. The Basic Approach represents a modified version of Basel I with slight definitional changes and incorporation of an operational risk capital charge. Additionally, AIs using this Approach will be subject to the requirements of Pillars 2 and 3 under Basel II. The Approach is intended for AIs with small (i.e. total assets not more than HK$10 billion), simple and straightforward operations, as well as AIs that have been approved by the HKMA to adopt or undergo transition to the IRB Approach by no later than end-2009. In practice, it will be available to nearly all restricted licence banks and deposit-taking companies, thus addressing those AIs' concerns over the complexity and cost of implementation.

PROPOSED LEGISLATIVE AMENDMENTS TO IMPLEMENT BASEL II

16. The current framework for measuring AIs' CARs is embodied in Part XVII of and the Third Schedule to the BO. These are supplemented by supervisory guidelines and technical notes issued by the Monetary Authority (MA) from time to time. Basel II involves a significantly more sophisticated approach to the calculation of CARs as compared with the present regime in the BO and extends its scope of application to cover also bank holding companies (BHCs). Consequently there is a need to amend the BO to provide for the revised legal framework for AIs and to establish a new framework for BHCs.

17. The proposed amendments to the BO for the purpose of implementing Basel II in Hong Kong basically relate to three major areas, namely capital adequacy ratio of AIs, imposition and policing of capital requirements on BHCs, and enhancement of the existing financial disclosure regime applicable to AIs. Each of these is discussed below.

<u>Capital Rules and Disclosure Rules</u>

18. Given the fact that the method of calculating CARs under Basel II is considerably more complex than that currently in the Third Schedule to the BO, putting the revised regime into legislation through the existing approach, i.e. by incorporating all the detailed calculations in the Third Schedule, is considered to be neither practical nor cost-effective. In addition, to keep pace with both developments in the industry which impact on CARs and international practices which will evolve over time, there will be a need on a continuing basis to revise and keep up-to-date the CAR regime in Hong Kong. These necessitate modification of the existing process for putting into legislation the revised capital regime in Hong Kong. It is therefore proposed

that a rule-making approach be adopted, under which the BO will be amended to provide for the introduction of a revised capital framework which will operate in accordance with rules promulgated by the MA.

19. For the above-mentioned purposes, it is proposed that the BO be amended to provide for the MA's power to promulgate the following two types of Rules:

Capital Rules

20. It is proposed that the legislation should provide that, after consultation with the BAC, the DTCAC, HKAB, the DTCA and the Financial Secretary, the MA may make rules prescribing the 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. Such rules are hereafter referred to as Capital Rules. The term "capital adequacy ratio" is proposed to be defined as the ratio of an institution's capital base to a value representing the degree of credit risk, market risk and operational risk to which the institution is for the time being exposed. In this definition, "credit risk" means the risk of default by counterparties in on-balance sheet and off-balance sheet transactions of the institution. "Market risk" means the potential losses arising from fluctuations in the value of positions held by the institution for trading purposes in debt securities, interest rate-related contracts, equities and equity-related contracts; and in foreign exchange, exchange rate-related contracts, commodities and commodity-related contracts. "Operational risk" means the risk of direct or indirect losses resulting from inadequacies or failings in the processes, personnel or systems of the institution or from external events. We are also thinking of defining the term "capital base" as an institution's paid-up capital, the amount standing to the credit of its share premium account, its audited retained earnings, its published reserves and such other resources as the MA may prescribe in the Capital Rules. It will also provide that the Capital Rules made under the BO shall provide for the MA, on application made to him by any person aggrieved by a decision made by the MA under the Rules, to review his decision.

Disclosure Rules

21. Currently, the BO provides in section 60 for the public disclosure of audited annual accounts by AIs and empowers the MA, under section 60A (which is not yet in operation), to require public disclosure of information relating to the state of affairs or profit or loss of AIs. The proposed legislation will build on these provisions for Pillar 3 purposes by extending section 60A and applying provisions similar to sections 60 and 60A to BHCs as well as AIs. Specifically, it is proposed that the MA be empowered to make rules, here referred to as Disclosure Rules, to prescribe the information to be disclosed to the general public by AIs and BHCs relating to their state of affairs, profit and

loss, and capital adequacy as well as the manner in which, times at which and periods during which such information shall be disclosed.

Proposed Rule Making Approach

22. It should be emphasised that it is not the Administration's intention to seek a general rule-making power for the MA under the BO, and the powers sought will be confined to those strictly necessary for the implementation of Basel II. It is proposed that the Rules made under the BO will have the status of subsidiary legislation and will be subject to negative vetting by the LegCo. Before issuing the Rules, the MA shall be obliged to consult relevant parties, including the BAC, the DTCAC, HKAB, the DTCA, and the Financial Secretary. The MA shall have the power to issue guidelines providing guidance to AIs and BHCs on the exercise of powers conferred on him under these Rules. As check and balance measures, provisions on appeal and procedural safeguards shall be incorporated into the BO with regard to the designation of and minimum capital requirement on BHCs as well as any decision of the MA made under the Rules. The decisions which are subject to appeal will be related to the calculation approach (e.g. the Basic Approach or the IRB Approach) to be adopted by a BHC or an AI under the Rules.

23. The proposed rule-making approach is comparable to that of the Securities and Futures Ordinance (SFO), under which the Securities and Futures Commission (SFC) is empowered to make rules, which are subsidiary legislation, on general and specific issues relating to the SFO, subject to certain procedures laid down therein. Similarly, the Deposit Protection Scheme Ordinance also contains provisions that give the Hong Kong Deposit Protection Board and the MA the power to make rules on various operational aspects of the Deposit Protection Scheme.

Imposition and policing of capital requirements on BHCs

24. The framework of Basel II is designed to apply not just to individual banks but also to bank holding companies, being parent entities within banking groups, to ensure that the risk that the whole banking group poses to an AI is captured in the risk assessment process. Therefore, it is proposed that the BO be amended for the imposition and policing of minimum CAR requirements in respect of BHCs. The main areas to be covered in this new regime include the following –

MA's power for the designation of BHCs

25. It is proposed that the MA may designate any controller of an AI as a BHC, in order to facilitate consolidated supervision. The use of this provision, however, will be very limited. A controller is not liable for designation if it is an AI incorporated in Hong Kong, or in the case of a

company that is incorporated outside Hong Kong, subject to adequate supervision by the relevant banking supervisory authority. The latter is to avoid regulatory overlap.

26. In practice, the decision to designate a controller as a BHC will depend on whether designation is required in the circumstances of the particular corporate group to fully capture risk within the banking group. It should also be noted that the MA already has the power (i.e. under s.70 of the BO) to impose conditions (including the maintenance of minimum CAR) on controllers of AIs. New provisions to require BHCs to maintain a minimum CAR, submit information and disclose financial information can be regarded as a more formal, transparent representation of the MA's existing general power. It is expected that only a very limited number of controllers would be designated as BHCs

Capital adequacy requirement

27. It is proposed that a BHC shall not, at any time, have a CAR of less than 8%, calculated on a consolidated basis in accordance with the Capital Rules. The MA may require the CAR of a BHC to be calculated in respect of such subsidiaries of the BHC as he may specify in a notice. The MA may, after consultation with a BHC, by notice in writing served on it increase the CAR of the company to not more than 16%. The proposed legislation will provide that Capital Rules shall provide for the MA, on application made to him by any person aggrieved by a decision made by him under the Rules, to review his decision.

Disclosure of information for Pillars 1 and 2 purposes

28. Basel II requires that supervisors should review and evaluate banks' and their holding companies' capital adequacy assessments and assess their compliance with minimum capital standards, taking into account the risks of the whole banking group. Therefore the proposed legislation should include provisions to the effect that all BHCs must satisfy the MA of their financial condition by submitting periodic returns and such other information as to enable the MA to assess the BHC's compliance with the CAR regime under Basel II. The new provisions will also require a BHC to appoint an individual as a chief executive (CE) and notify the MA in writing of the identity of its CE and all its directors. The MA may require the CE and the directors of the BHC to meet with the MA if he considers it desirable to assist him in the performance of his functions under the BO.

Disclosure of information for Pillar 3 purpose

29. It is proposed that the MA may, after consultation with the Financial Secretary, the BAC, the DTCAC, the HKAB and the DTCA, make

rules prescribing the information to be disclosed by BHCs to the general public. Such disclosure would include information relating to their state of affairs, profit or loss and capital adequacy ratio in such manner and at such times as the MA may require.

Appeal Mechanism

30. It is proposed that the MA should, before designating a controller as a BHC, give the controller an opportunity of being heard within 14 days. The proposed legislation will also provide for persons aggrieved by a decision of the MA, made in the exercise of a power conferred by the Capital Rules, regarding the calculation approach (e.g. the Basic Approach or the IRB Approach) to be adopted by a BHC or an AI, to appeal to the Chief Executive in Council against such decision. However, such decisions would take effect immediately notwithstanding that an appeal has been or may be made.

Penal Provisions

31. In line with the existing penal provisions applicable to AIs, the proposed legislation should impose a penalty on every director and CE of BHCs in circumstances such as failure to notify the MA of the BHC's failure to maintain a CAR of not less than 8%, or contravention of any requirement contained in a notice of the MA served on the BHC requiring remedial actions to be taken for complying with the minimum CAR and the Capital Rules. Similar penalty provisions will also be included for the CE and directors of BHCs for failure to lodge the BHC's audited annual accounts and related documents with the MA, failure to exhibit the documents lodged with the MA in a conspicuous position in the principal place of business in Hong Kong of the relevant AIs, failure without reasonable excuse to submit information to the MA as required in a notice in writing, and failure to comply with any requirement applicable to BHCs contained in the Disclosure Rules.

REVIEW OF OFFENCE PROVISIONS AND OTHER AMENDMENTS

32. The Administration considers it desirable to introduce legislative amendments to the BO so as to improve the working of certain provisions of the BO in the light of experience. The other major amendments under the proposed legislation under preparation are as follows :

Vicarious liability for managers

33. It is proposed to amend section 2 of the BO so that the vicarious liability of managers of an AI for offences under the BO extend only to those managers who caused or contributed to the contravention personally or through an act or omission of a person under his control (instead of extending liability

to every manager of the AI, as at present). Both the HKAB and the DTCA have been consulted on this issue. They support in principal our proposal to refine the scope of vicarious liability of managers under the penal provisions.

<u>Publication of disciplinary action on AIs' securities business</u>

34. The MA has been empowered under the Banking (Amendment) Ordinance 2002 to use the same standards and approaches adopted by the SFC in the MA's front-line supervision of AIs' securities business. Currently, the SFC publishes its disciplinary action as well as the relevant facts and findings surrounding the case. Although the MA has been given similar powers under sections 58A and 71C of the BO, there is doubt as to whether the MA can publish his disciplinary actions in view of the confidentiality obligations imposed on him by section 120 of the BO. To maintain a level playing field between AIs and SFC regulated persons, it is proposed to amend the relevant provisions in the BO to put it beyond doubt that the MA may publish his disciplinary decisions in a manner similar to that followed by the SFC.

WAY FORWARD

35. Hong Kong is one of the first jurisdictions globally to put together its draft implementation guidelines for Basel II. 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.

36. The HKMA is collaborating with the Department of Justice and the Financial Services and the Treasury Bureau to produce a draft of the Banking (Amendment) Bill 2005 for implementing the Basel II regime. The draft Bill is expected to be available for industry consultation by early December 2004. Subject to any further comments of the statutory committees and the industry and the approval of the Chief Executive in Council, it is expected that the Bill will be introduced into LegCo in Q2/2005.

Hong Kong Monetary Authority
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