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Panel on Financial Affairs
Meeting on 6 December 2004

Background Brief
on the proposed implementation
of the New Basel Capital Accord in Hong Kong

Purpose

This paper sets out the background of the Administration's proposal of implementing a new capital adequacy framework for authorized institutions (AIs) in Hong Kong, and summarizes the major views and concerns expressed by Members when the proposal was deliberated at the meeting of the Panel on Financial Affairs (FA Panel) on 5 July 2004.

Background

2. The international standards in the field of banking supervision are set by the Basel Committee on Banking Supervision (the Basel Committee)[Note]. Hong Kong is not a member of the Basel Committee, but together with around 100 other supervisors world-wide has pledged to adopt the standards set by the Committee.

3. A key element of the Basel supervisory approach is the capital adequacy ratio (CAR) set out in the Basel Capital Accord adopted in 1988 (widely referred to as "Basel I"). The CAR is important because it provides a buffer against losses, thus providing protection to depositors. Under Basel I, the CAR is calculated by dividing a bank's capital base by its risk-weighted assets (arrived at by multiplying each asset class by the specified risk weight), and the minimum CAR is 8%.

Note

The Basel Committee on Banking Supervision was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives from banking supervisory authorities and the central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. The Committee usually meets at the Bank for International Settlements (BIS) in Basel, where its permanent Secretariat is located.

4. Basel I and its subsequent amendments have been adopted in Hong Kong through legislation under Part XVII of and the Third Schedule to the Banking Ordinance (BO) (Cap. 155). The detailed requirements for computing CAR requirements are set out in the legislation and supplemented by supervisory guidelines and technical notes issued by the Hong Kong Monetary Authority (HKMA). While AIs in Hong Kong are required to maintain a minimum CAR at 8%, most AIs are maintaining an average ratio of 15% - 16%.

5. In order to address the limitation of Basel I and respond more directly to the financial developments in recent years, the Basel Committee issued in June 1999 a proposal for a New Basel Capital Accord ("Basel II") to replace Basel I. Basel II aims to provide an impetus to, and incentive for, banks to enhance risk measurement and management capabilities, and to promote market discipline by means of improved disclosure. It is a major step forward in terms of identification, quantification and management of risk.

6. The Basel Committee finalized and published Basel II by the end of June 2004. The new framework would be implemented globally by the end of 2006, while the most advanced approaches for credit risk and operational risk would be implemented by the end of 2007.

7. At the FA Panel meeting on 5 July 2004, members were briefed by the Administration on the proposed implementation of Basel II in Hong Kong. Members noted that HKMA had engaged in extensive consultation with the banking industry over the past few years in developing the implementation plan on Basel II and the industry was supportive of the proposed approach for implementation. HKMA planned to implement Basel II in Hong Kong by the end of 2006 for the simpler approaches and by end of 2007 for the most advanced approaches to tie in with the timetable of the Basel Committee. Members also noted that since the method of calculating CAR requirements under Basel II would be considerably more complex, substantive legislative amendments to the BO were expected. The Administration aimed at introducing the relevant bill into the Legislative Council (LegCo) in 2005.

Main features of Basel II

8. Basel II is built on three pillars, as follows:

(a) Pillar 1

- Pillar 1 sets out the minimum capital requirements. It maintains the minimum CAR requirement of 8% but extends the requirement on a consolidated basis to holding companies of banking groups. The calculation of the minimum CAR will cover a bank's exposure to operational risk, in addition to credit risk and market risk.

- For credit risk, a bank may use the Standardized Approach, which is based on ratings assigned to bank exposures by external agencies, or the Internal Ratings Based (IRB) Approaches, which use internal rating models to quantify risks. Depending on the level of sophistication of the bank's internal rating system, it may choose either the Foundation IRB Approach or Advanced IRB Approach. The operation of the Standardized Approach is similar to the current system, but with the important difference that the risk weights will be linked to external ratings and various risk mitigation techniques.
- For operational risk, Basel II allows banks to choose from three measurement approaches, namely the Basic Indicator Approach (i.e. a single fixed percentage is applied to a bank's total income), the Standardized Approach (i.e. fixed percentages, set by supervisors, are applied to the gross income of eight predetermined business lines of a bank), and the Advanced Measurement Approaches (i.e. based on internally-generated risk measures with the bank's internal risk measurement systems subject to supervisory validation).
- As regards market risk, banks may choose between two approaches, i.e. the Standardized Approach and the Internal Models Approach.

(b) Pillar 2

Pillar 2 covers the supervisory review process of a bank. It requires a bank to put in place sound internal processes to assess the adequacy of its capital, based on a thorough evaluation of its 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 become insufficient.

(c) Pillar 3

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. It applies at the top consolidated level of the banking group to which Basel II applies.

Major views and concerns expressed by members at the meeting of the Panel on Financial Affairs

9. At the FA Panel meeting on 5 July 2004, members indicated general support for the implementation of Basel II in Hong Kong with a view to improving risk management of banks. Members noted that the new capital adequacy regime would bring significant benefits to Hong Kong by enhancing the safety and stability of the banking sector, increasing the ability of banks to assess and lend to sectors such as the small and medium-sized enterprises, and reducing banks' reliance on collateral in granting loans. Some members urged HKMA to conduct extensive consultation with the industry to work out the implementation plan and to expedite preparatory works for the early implementation of the new regime. Some members have however expressed the following views and concerns:

(a) As the medium and small-sized banks in Hong Kong are expected to adopt the standardized or a more simplified approach in managing their risks, they may not fully benefit from the new capital regime and may become less competitive vis-à-vis large banks in the market;

(b) While the banking industry is in support of the proposed implementation of Basel II in Hong Kong, the industry is concerned about the cost implication of the proposal, such as the cost for banks to improve their risk management systems; and

(c) The requirement under Pillar 2 of Basel II for a banking regulator to intervene if a bank's capital level becomes insufficient may adversely affect the operation of the bank.

The extract of the minutes of the FA Panel meeting is in the **Appendix**.

Latest developments

10. In early August 2004, HKMA issued the proposals for implementing Basel II in Hong Kong for consultation of the banking industry up to end of October 2004. According to HKMA's proposals, a rule-making approach will 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 the rules promulgated by the Monetary Authority. The rules will be subsidiary legislation subject to the negative vetting by LegCo. Moreover, given that the current capital regime in Hong Kong under the BO only extends to AIs incorporated in Hong Kong but not their holding companies, i.e. BHCs, the BO will also be amended to provide for a capital framework for BHCs.

11. At the LegCo meeting on 13 October 2004, the Chief Secretary for Administration presented the Legislative Programme for the 2004-05 session. The Legislative Programme includes the Banking (Amendment) Bill which seeks to implement the New Basel Capital Accord and to improve the working of the BO in the light of experience.

Council Business Division 1
Legislative Council Secretariat
1 December 2004

Appendix

Extract from the minutes of meeting of the Panel on Financial Affairs on 5 July 2004

Action

III. Briefing on the implementation of the Basel New Capital Accord in Hong Kong

(LC Paper No. CB(1)2254/03-04(03) — Paper provided by the Administration)

Briefing by Hong Kong Monetary Authority

6. At the Chairman's invitation, the Executive Director, Banking Policy Department, Hong Kong Monetary Authority (ED(BPD)/HKMA) gave a power-point presentation on the new capital adequacy standards for banks to be issued by the Basel Committee on Banking Supervision (Basel II) and HKMA's plans to implement the new standards in Hong Kong. The salient points were summarized as follows:

(a) The international standards in the field of banking supervision were set by the Basel Committee on Banking Supervision. A key element of the Basel supervisory approach was the capital adequacy ratio (CAR) set out in the Basel Capital Accord adopted in 1988 (Basel I). Basel I and its subsequent amendments had been adopted in Hong Kong through legislation under the Third Schedule to the Banking Ordinance (BO) (Cap. 155).

(b) The capital held by a bank helped to absorb losses and thus protect its creditors (primarily depositors) in the event that a bank was wound up. CAR was calculated by dividing a bank's capital base by its risk-weighted assets. The minimum CAR under Basel I was 8%. While the authorized institutions (AIs) in Hong Kong were required to maintain a minimum CAR at 10%, most AIs were maintaining an average ratio of 15% - 16%.

(c) Basel I had become outdated as the financial world had evolved significantly. The current capital framework had become too broad-bush and insufficiently "risk-sensitive" and failed to

capture many other risks that banks faced. Moreover, it did not provide the proper incentives for banks to apply risk mitigation techniques. Hence, the Basel Committee had proposed Basel II to replace Basel I. Basel II aimed 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.

(d) Basel II was built on three pillars. Pillar 1 set out the minimum capital requirements. It maintained the minimum CAR requirement of 8% but the calculation would be extended to cover a bank's exposure to operational risk, in addition to credit risk and market risk. Different approaches for each type of risks were available for adoption by individual banks. For instance, in calculating credit risk, a bank could use the Standardized Approach, which was based on ratings assigned to bank exposures by external agencies, or the Internal Ratings Based (IRB) Approach, which used internal rating models to quantify risks. Depending on the level of sophistication of the bank's internal rating systems, it might choose either the Foundation IRB Approach or Advanced IRB Approach.

(e) It was envisaged that large international banks would adopt the IRB Approach while small banks would use the Standardized Approach. The operation of the Standardized Approach was similar to the current system, but with the important difference that the risk weights would be linked to external ratings and various risk mitigation techniques. There would be preferential weightings for residential mortgage loans and retail lending, as well as lending to small and medium-sized enterprises (SMEs). Similarly, methods of varying sophistication would be available in respect of operational risk.

(f) Pillar 2 covered the supervisory review process of a bank. It required a bank to put in place sound internal processes to assess the adequacy of its capital, based on a thorough evaluation of its risks, including those risks not covered under Pillar 1, such as interest rate risk in the banking book and reputational risk. Banks were expected to hold capital above the regulatory minimum and supervisors must intervene at an early stage if capital levels became insufficient.

(g) Pillar 3 was 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.

(h) The Basel Committee had finalized and published Basel II by the end of June 2004. The new framework would be implemented globally by the end of 2006, while the more advanced approaches for credit risk and operational risk would be implemented by the end of 2007.

(i) Greater risk sensitivity of Basel II and inclusion of wide range of risks would further enhance safety and stability of the banking sector in Hong Kong. Moreover, implementation of Basel II in Hong Kong would also enhance Hong Kong's reputation and position as an international banking centre. Although the new capital regime carried significant implementation costs, the investment was fully justified on a cost/benefit basis.

(j) HKMA had engaged in extensive consultation with the industry over the past few years in developing the implementation plan on Basel II. The industry was supportive of the proposed approach for implementation. HKMA planned to implement the new capital adequacy regime in Hong Kong by the end of 2006 to tie in with the timetable of the Basel Committee. HKMA would adopt a menu approach to incorporate the various approaches for capital measurement under Pillar 1. The choice of options would be left to individual AIs subject to HKMA being satisfied that the choices were appropriate given the nature and scale of their activities.

(k) Since the method of calculating CAR under Basel II would be considerably more complex, substantive legislative amendments to BO were expected. The Administration was considering the possible legislative approaches. One of the possible options was to provide HKMA with the power to make rules on the details for calculating capital requirements. While the rule-making power would be set out in the principal ordinance, the rules would be subsidiary legislation subject to negative vetting by the Legislative Council (LegCo). The Administration aimed at introducing a banking amendment bill into LegCo in early 2005. It would update the Panel on the subject when there were more concrete proposals on legislative changes.

(*Post-meeting note:* The presentation material was circulated to members vide CB(1)2322/03-04(01) on 6 July 2004.)

Discussion

Implementation of Basel II in Hong Kong

7. Ms Emily LAU indicated her support for the implementation of Basel II in Hong Kong with a view to improving risk management of banks. She noted that the new capital adequacy regime would bring significant benefits to Hong Kong by enhancing the safety and stability of the banking sector, increasing the ability of banks to assess and lend to sectors such as SMEs, and reducing banks' reliance on collateral in granting loans. Ms LAU urged HKMA to expedite its work for the early implementation of Basel II.

8. Mr SIN Chung-kai expressed support of Members of the Democratic Party for the implementation of Basel II in Hong Kong. He urged HKMA to conduct extensive consultation with the industry to work out the implementation plan and to brief Members on further details after commencement of the new LegCo term in October 2004.

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9. Mr Kenneth TING welcomed the implementation of Basel II in Hong Kong. He enquired whether HKMA would stipulate a deadline for AIs to comply with the new capital requirements and whether it would provide incentives to encourage AIs in meeting the new standards.

10. ED(BPD)/HKMA advised that HKMA expected that AIs would make gradual improvement in their risk management systems from end of 2006 onwards and that most of them would fully comply with the new requirements by 2009. However, the implementation timetable could be adjusted in the light of developments in the market. ED(BPD)/HKMA re-iterated that the implementation process would be market driven. Market competition would exert pressure on banks to expedite improvement in their risk management systems.

Approaches for managing credit risks

11. Mr Henry WU enquired about the mechanism for determining AIs' risk management approaches. ED(BPD)/HKMA advised that HKMA would not determine the approaches to be adopted by individual AIs. AIs were expected to choose their own approach having regard to their perception of the market, their position in the market and their own aspirations. HKMA would offer advice to individual AIs and ensure that the approaches chosen by them were suitable for their types of businesses. Moreover, enhancement of public disclosure would allow customers to get to know individual AIs' choices in their risk management approaches. Consultation with the industry indicated that the largest banks and most of the medium-sized banks had aspired to adopt the IRB approach. However, given the sizeable investments for the

implementation of Basel II, the small-sized banks would adopt a simplified approach, which would be a variant of the Basel I regime. The simplified approach for credit risk management would only be an option for the small-sized banks (including deposit-taking companies and restricted licensed banks) with assets not more than $10 billion.

12. As large banks in Hong Kong were expected to adopt sophisticated approaches in managing their credit risks whereas the medium and small-sized banks might adopt the standardized or a more simplified approach, Ms Emily LAU was concerned that medium and small-sized banks would not fully benefit from the new capital regime and might become less competitive in the market. Mr Henry WU shared her concern.

13. ED(BPD)/HKMA envisaged that AIs would adopt different approaches in managing their credit risks with due regard to their respective needs and circumstances. It was believed that individual AIs would make improvement in their risk management system to catch up with the market development. Notwithstanding that implementation of Basel II could increase market competition and might therefore accelerate the consolidation of the banking industry, medium and small-sized banks would still have their own niche if they developed appropriate business strategies and risk management systems.

Cost for implementing Basel II

14. While expressing the banking industry's support for the implementation of Basel II in Hong Kong, Mr NG Leung-sing remarked that the industry was concerned about the cost implication of the proposal. In this connection, Mr Henry WU enquired about the estimated costs for banks to improve their risk management systems.

15. ED(BPD)/HKMA advised that the additional cost would be negligible for small-sized AIs adopting the simplified approach, as few changes would be required for their existing risk management systems. For AIs adopting the Standardized Approach, some changes in their information technology (IT) systems would be required. But it was expected that the cost involved would be absorbed in the budgets for on-going improvements in the systems. As regards AIs adopting the IRB approach, the cost would vary among institutions depending on the current state of their risk management and IT systems. For large international banks already equipped with advanced risk management systems, they would only be required to fine-tune their systems and the cost involved would not be significant.

Regulatory regime for compliance of requirements under Basel II

16. Mr NG Leung-sing noted that Pillar 2 under Basel II required regulators to intervene at an early stage if the capital level of a bank became insufficient. He expressed concern about providing HKMA with such power of intervention, which might adversely effect the operation of the banks concerned.

17. ED(BPD)/HKMA advised that under Basel II, banks would be required to assess their own risks in running businesses and to decide the capital levels to be maintained subject to verification by HKMA that the levels were sufficient to guard against the risks faced by the banks. This approach would be different from the existing regime where the capital levels were determined by HKMA. As such, it would be necessary to provide HKMA with the power of intervention to require banks to increase their capital levels should such a need arise. ED(BPD)/HKMA stressed that HKMA was aware of the importance of striking a proper balance between the need to provide banks with operational flexibility and the need to maintain a regulatory power to step in when there were problems. As regards sanctions on banks for failure to comply with the new capital level, ED(BPD)/HKMA advised that a range of supervisory tools were available for HKMA to rectify problems relating to capital adequacy requirements. However, he believed that HKMA would not invoke the power of intervention unless under very exceptional circumstances.

Proposal of issuing a White Bill on Basel II

18. Given the complexity of the subject and the technical issues involved, Mr SIN Chung-kai considered it advisable for the Administration to publish a White Bill on the legislative proposal to facilitate consultation with the public and the industry, and scrutiny of the banking amendment bill by LegCo. However, Mr Kenneth TING opined that it might not be appropriate to publish a White Bill on very technical legislative proposals.

19. ED(BPD)/HKMA said that HKMA was mindful of the need to engage full consultation with the industry in developing the appropriate legislative approach for implementing Basel II. It planned to issue a consultation paper on the general approach of the new capital regime, which would outline the technical issues involved. He assured members that the Administration would work out a draft bill for wide consultation.