LC Paper No. CB(1)2254/03-04(03)

For information
On 5 July 2004

LegCo Panel on Financial Affairs

The New Capital Accord ("Basel II")

I. PURPOSE

This paper and accompanying briefing aim to inform the Panel of:

(a) the new capital adequacy standards for banks to be issued by the Basel Committee on Banking Supervision (variously known as "the New Basel Capital Accord" and "Basel II"); and

(b) the HKMA's plans to implement Basel II in Hong Kong.

II. THE EXISTING CAPITAL ADEQUACY FRAMEWORK (BASEL I)

2. The international standards in the field of banking supervision are set by the Basel Committee on Banking Supervision[1] ("BCBS"). Hong Kong is not a member of BCBS, but together with around 100 other supervisors world-wide has pledged to adopt the standards set by the Committee. In addition, the International Monetary Fund and World Bank use the Basel supervisory standards as a benchmark in conducting their assessments.

3. The capital held by a bank helps to absorb losses and thus protect its creditors including depositors. Consequently, bank supervisors have an interest in maintaining adequate capital in the banking system and have used their authority to impose minimum capital requirements. A key element of the Basel supervisory approach is, therefore, the capital adequacy ratio (CAR) requirement set out in the Basel Capital Accord adopted in 1988 (now widely-referred to as Basel I). The Accord 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 CAR is

[1] 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. Currently, the Committee reports to the central bank Governors and heads of supervision of the G10 countries. The Committee usually meets at the Bank for International Settlements (BIS) in Basel, where its permanent Secretariat is located. It formulates broad supervisory standards and guidelines and recommends statements of best practice. In close collaboration with many non-G10 supervisory authorities, the Committee also aims to promote sound supervisory standards world -wide.

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); the resultant ratio must be at least 8%. 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.

4. Basel I and its subsequent amendments have been adopted by Hong Kong through legislation under the Third Schedule to the Banking Ordinance ("BO"). Globally, the 1988 Accord has been applied in some form in over 100 countries and has become the common benchmark for banking solvency around the world.

5. Since the current framework was first introduced, technological advancement, innovations in financial products as well as increasing globalisation have dramatically changed the nature of banks' business and the risks they are running. As a result, the current framework has become too broad-brush and insufficiently "risk-sensitive" and has failed to capture many other risks that banks face. In other words, the current framework no longer functions effectively as a mechanism for ensuring that banks hold an amount of capital that is broadly commensurate with the risks they run.

III. THE NEW BASEL CAPITAL ACCORD (BASEL II)

6. In order to address the shortcomings of Basel I and respond more directly to recent financial developments, the Basel Committee issued in June 1999 a proposal for a New Basel Capital Accord to replace the 1988 framework. In revising the Accord, the Basel Committee defined five objectives. The Accord should:

- continue to promote safety and soundness in financial system;
- continue to enhance competitive equality;
- constitute a more comprehensive approach to addressing risks;
- contain approaches to capital adequacy that are sensitive to the degree of risk; and
- focus on internationally-active banks, but its underlying principles should be applicable to others.

7. Basel II aims to provide an impetus to, and incentives for, banks to enhance their risk measurement and management capabilities, and to promote market discipline by means of improved disclosure. It has gained widespread support by countries with active international banks. Apart from the G-10 countries, non-G10 countries such as Australia and Singapore are planning to adopt the New Capital Accord according to the Basel timetable while some others in the Region are considering implementation at a later stage.

8. On 11 May, the Basel Committee announced that the new capital framework would be finalised and published by end-June 2004. The Committee confirmed that the standardised and foundation IRB approaches (see below) will be implemented from year-end 2006, while the most advanced approaches for credit risk and operational risk will be implemented at year-end 2007 due to the need for one further year of impact analysis and parallel running.

Basic features of the new capital framework

9. Basel II is built on three pillars: minimum capital requirements; supervisory review; and market discipline.

Pillar 1 – minimum capital requirements

10. The first pillar sets out 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. It also prescribes how the minimum capital adequacy ratio is to be calculated for a bank's exposures to credit risk, market risk and operational risk. The credit risk measurement methods are more elaborate than those in Basel I. While the market risk measure remains unchanged, Basel II introduces a new capital charge for operational risk (i.e. the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events).

11. For credit risk, Basel II allows banks to use different approaches based either on ratings assigned to bank exposures by external agencies (standardised approach) or internally assigned through supervisor-validated models using default probabilities (Internal Ratings Based or IRB approaches). Depending on the level of sophistication of banks' internal rating systems, banks may choose either the Foundation IRB Approach or Advanced IRB Approach.

12. For operational risk, three measurement approaches are available for banks to choose. They are, in order of increasing sophistication: the Basic Indicator Approach (a single fixed percentage is applied to a bank's total income); Standardised Approach (fixed percentages, set by supervisors, are applied to the gross income of eight predetermined business lines of a bank); and Advanced Measurement Approaches (based on internally-generated risk measures with the bank's internal risk measurement systems subject to supervisory validation).

Pillar 2 – supervisory review process

13. This Pillar requires supervisors to ensure that each bank has sound internal processes in place to assess the adequacy of its capital, based on a thorough evaluation of its risks (including risks such as interest rate risk in the banking book which have not been captured under Pillar 1). It stresses the importance of a

bank's management setting capital targets that are commensurate with the bank's particular risk profile and control environment. Banks are expected to hold capital above the regulatory minimum and supervisors must intervene at an early stage if capital levels become insufficient.

Pillar 3 – market discipline

14. The purpose of this Pillar is to complement Pillar 1 and Pillar 2 by encouraging market discipline through the disclosure of key information on capital, risk exposure and risk assessment. It applies at the top consolidated level of the banking group to which Basel II applies.

IV. APPLICATION TO HONG KONG

15. As a major IFC which prides itself on adopting the latest best practices, it is natural for Hong Kong to implement Basel II at the same time as the Basel Committee members. We believe that the greater risk sensitivity of Basel II and the inclusion of a wider range of risks will further enhance the safety and stability of the banking sector. Moreover, we believe that implementation will enhance the reputation and standing of Hong Kong – and of our banks – in the international arena, including in the context of external ratings, in line with market expectations. But, most important of all, we believe that the improvements in risk management required under Basel II are a necessary business requirement for the Hong Kong banking sector. Better understanding and management of risk is an essential element in maximising risk-adjusted return. In other words, the implementation/investment is fully justified on a cost/benefit basis; it is not a case of burdening banks with unnecessary regulatory or compliance costs, but of giving them a nudge in the direction of improving their risk management. Taking all these together, there is, therefore, a very persuasive case for implementing Basel II in Hong Kong.

16. Major international banking groups with a presence here will implement Basel II, the more advanced approaches specifically, globally in 2006. They naturally expect to adopt the same implementation approach and timetable in their operations in Hong Kong. The indigenous local banks also recognise the business need to implement Basel II, given the benefits of improved risk management and disclosure. For example, improved risk management offers them the prospect of better risk-adjusted pricing (i.e. lower interest rates for better customers); increased ability to assess and lend to sectors such as SMEs; increased ability to offer sophisticated products (e.g. derivatives); and enhanced public confidence in the banks.

17. The HKMA has engaged in extensive consultation over the last several years in order to develop its plan to implement Basel II in Hong Kong and command the support of the industry for the implementation. The industry is

supportive of our proposed approach to implementation. The latest indications are that all of the eight largest banks in Hong Kong will adopt the IRB approach, although not all by end-2006, while most other banks are likely, at least initially, to adopt the standardised approach. It may not be justified on a cost-benefit basis, however, for the very smallest institutions, including many DTCs & RLBs, to make the sizeable investments (IT, systems/models, human resources) necessary to implement Basel II. Therefore, we are prepared to allow them to adopt a more simplified approach which is likely to be a variant of Basel I incorporating an operational capital charge.

V. HKMA'S PROPOSED IMPLEMENTATION PLAN

18. In the interests of systemic stability and providing a measure of protection to depositors, the HKMA plans to implement Basel II in Hong Kong by end-2006 according to the Basel timetable. All the three pillars will be implemented at the same time. The HKMA has developed a detailed work plan for implementation and we are well-advanced in our preparations.

19. It is recognised that AIs vary widely in terms of their business focus, size and complexity, as well as the nature and combination of risks they face. In order to have rules that are appropriate to different AIs, therefore, we propose to adopt a menu approach for Pillar 1. This means that the various approaches for capital measurement under Pillar 1 (apart from the Advanced Measurement Approaches for measuring operational risk capital charge which entails the use of evolving quantitative techniques still subject to much debate internationally) will be incorporated in the revised capital regime, with the choice of options left up to individual AIs. However, the HKMA has to be satisfied that the AIs' choices are appropriate given the nature and scale of their activities.

20. The extensive consultation undertaken over the last several years has helped ensure that our implementation plans are pragmatic, strike an appropriate balance between regulation and market forces, take into account of costs and benefits, and command the support of the industry. The industry is, indeed, supportive of the approach. On-going consultation with the industry will continue on the process of implementation. Specifically, a Basel II Consultative Group consisting of industry representatives, representatives of the accounting profession, and other interested parties has been formed to advise the HKMA on issues relating to implementation.

21. The Basel Committee's new proposals, which run to many hundreds of pages, embody a significantly more sophisticated approach to the calculation of CARs as compared with the present regime currently in the BO. The method of calculating CARs will be considerably more complex than that currently in the Third Schedule. Furthermore, it is anticipated that to keep pace with both developments in the industry which impact on CARs and international practice

which will evolve over time, there will be a need on a continuing basis to revise and thereby keep up-to-date the CAR regime in Hong Kong. Therefore, the legislation for Basel II under the BO is a key and challenging issue in the implementation process. The Financial Services and the Treasury Bureau and the HKMA are considering possible legislative approaches and aiming at submitting a Banking Amendment Bill during the 2004/2005 legislative session. We will keep the Panel updated when there are more concrete proposals on legislative changes.

VI. CONCLUDING REMARKS

22. While the implementation challenges for banks and the HKMA are not inconsiderable, good progress is being made. The fact that Hong Kong plans to be one of the first non-Basel jurisdiction to implement Basel II is positive for Hong Kong. It keeps us at the forefront regionally and internationally, reinforcing that we are on a par with the world's top international financial centres. Of course there are implementation costs, but we anticipate a lot of benefits, namely: enhancement of the safety and stability of the banking sector; enhancement of the reputation of the banking sector and of the supervisory system; and in particular enhancement of the banking sector's ability to take on and manage risk, crucial to their role of financing growth in the economy.

Hong Kong Monetary Authority
June 2004