For information

Legislative Council Panel on Financial Affairs

Progress of preparations for the implementation of Basel II in Hong Kong

Purpose

This paper reports on the progress of preparations for the implementation of Basel II in Hong Kong.

2. The Banking (Amendment) Ordinance 2005 (BAO 2005), enacted in July 2005, amends various sections of the Banking Ordinance (BO) as necessary to establish the new capital regulatory regime for authorized institutions (AIs). One of the key amendments is the provision of a rule-making power enabling the Monetary Authority (MA) to promulgate rules prescribing the manner in which AIs' capital adequacy ratio (CAR) shall be calculated and information on financial affairs that AIs shall disclose. These rules, referred to as "Capital Rules" and "Disclosure Rules", will have the status of subsidiary legislation and will be subject to negative vetting by the Legislative Council.

3. This paper focuses in particular on the preparation of the rules, the consultation process, and preparations for the establishment of the Capital Adequacy Review Tribunal pursuant to the BAO 2005.

Background

4. The Capital Rules and Disclosure Rules ("the Rules") to be made by the MA under the new sections 98A and 60A of the BO (as in sections 4 and 2 of the BAO 2005 – set out in <u>Annex A</u>, which are not yet in operation), will form an integral part of a new capital regulatory regime to be adopted in Hong Kong to implement, in a manner considered appropriate for the particular circumstances of the local banking industry, the proposals contained in "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (commonly known as "Basel II") issued by the Basel Committee on Banking Supervision ("Basel Committee").

5. The proposals of the Basel Committee set out in Basel II have gained widespread international acceptance and the Government considers that, given Hong Kong's position as an international finance centre, it should be in the first wave of jurisdictions (alongside other major international financial centres such as London, Paris, Frankfurt and Tokyo) to establish a legal and regulatory framework broadly in

line with the international standards in Basel II. In implementing Basel II, however, due consideration should be given to, and appropriate adjustments should be made for, the particular circumstances of the local banking industry. Careful cost/benefit analysis should be undertaken, the aim being to make implementation as cost-effective as possible, and the additional cost burden placed on AIs by the new requirements should be explicitly taken into account.

6. The Capital Rules will set out the manner for calculating the CAR which AIs incorporated in Hong Kong must maintain. Nearly all jurisdictions with active banking markets require banking organisations to maintain at least a minimum level of capital to serve as a foundation for a bank's future growth and as a cushion against its unexpected losses. Capital levels are usually considered in the form of a capital adequacy ratio, expressed as a percentage, of a bank's capital base (being equity share capital, reserves, certain forms of subordinated debt and the like) to its exposures (which are allocated risk weights according to the class of obligor or exposure).

7. The Third Schedule to the BO, which sets out how the minimum capital requirement should be calculated under the existing framework, will be repealed when the Capital Rules are made.

8. The Disclosure Rules will set out the requirements for the public disclosure which AIs must make in respect of their profit and loss, state of affairs and CAR.

9. The MA has also been empowered under the BAO 2005 to issue guidelines to AIs on the manner in which the MA exercises his rule-making power.

10. In devising Basel II, the Basel Committee set itself the dual objectives of enhancing the risk sensitivity of the existing capital adequacy measure and providing incentives for banks to enhance risk measurement and management. Basel II is considerably more complex than its predecessor, Basel I. It extends the calculation of the CAR to cover a bank's exposure to operational risk, in addition to credit risk and market risk.[1] Moreover, different calculation approaches for each type of risk are available for adoption by individual banks, depending on their level of sophistication and risk profile.[2]

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[1] This is one of the three "pillars" of the Basel II requirements, Pillar 1, which sets out the minimum capital requirement for a bank's credit, market and operational risks. Pillar 2 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, and that supervisors should carry out "supervisory review" of this process. Pillar 3 is to complement Pillars 1 and 2 by requiring banks to make public disclosure of their risk profiles, capital adequacy and internal risk management. Further details are given in Annex B to this paper.

[2] The menu of approaches to measuring risks, in order of increasing sophistication, for banks to choose under Basel II are: the Standardised Approach, the Foundation Internal Ratings–Based (IRB) Approach, and the Advanced IRB Approach for credit risk; the Basic Indicator Approach, the Standardised

Implementation timetable

11. Hong Kong's Basel II implementation timetable is in accordance with that recommended by the Basel Committee for its own members and endorsed by the industry. From January 2007, all AIs incorporated in Hong Kong will be required to follow Basel II. Initially, they will have a choice of three options for credit risk, namely Standardised Approach, Basic Approach, and Foundation IRB Approach, and from January 2008 a fourth option, namely Advanced IRB Approach, will be added. AIs choosing to adopt either of the IRB approaches can set their own implementation timetable. In other words, they can start on the Standardised or Basic Approach in January 2007, and then migrate to IRB whenever it suits them (as long as they can meet the qualifying criteria). This flexibility is appropriate because different AIs are at different stage of preparation for IRB, and some will be ready sooner than others; and because the large international banks are working to varying timetables (and some wish to implement IRB in all jurisdictions at the same time, while others wish to phase implementation). Legislation of all approaches by January 2007 will provide AIs with the certainty they need to plan their implementation of the revised capital regime.

12. The MA will continue to set minimum CARs for AIs on a case-by-case basis, in the range of 8-16% as provided for under section 101(1) of the BO. A draft guideline setting out the process by which the HKMA evaluates and monitors the capital adequacy of AIs and set the minimum CAR of AIs has been issued for industry consultation.

Major preparatory tasks

Policy setting

13. The HKMA has already issued all relevant Basel II implementation proposals, all of which have been endorsed by the banking industry. This means that the policy-setting stage of our implementation plan has been completed. The industry has played a critical role in this process, helping to ensure that the framework and the implementation approach are tailored to Hong Kong's circumstances while meeting the international standards required of banks. In converting the Basel II document into implementation proposals, the HKMA's work has benefited from the advice of the Basel II Consultation Group (BCG), which included representatives from the industry, the accounting profession and other interested parties; the two statutory advisory committees, i.e. the Banking

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Approach and the Advanced Measurement Approaches for operational risk; and the Standardised Approach and Internal Models Approach for market risk. For Hong Kong, the Hong Kong Monetary Authority (HKMA) has also made available a "Basic Approach" to measuring credit risk, which is essentially a modification of the existing framework and is mainly intended for use, with the prior approval of the MA, by AIs with small, simple and straightforward operations, and as an interim approach for those AIs developing IRB systems.

Advisory Committee and the Deposit-Taking Companies Advisory Committee; the two industry Associations, i.e. The Hong Kong Association of Banks and the DTC Association; other parties within the Government; and other interested parties.

Development of rules

14. Translating the Basel II requirements into legislation is a major task which different jurisdictions will undertake in different ways. The approach we have adopted in Hong Kong is that the HKMA has engaged a consultant draftsman to assist in the production of detailed Drafting Instructions (in the form of draft rules) so as to facilitate the drafting process. The HKMA, the Financial Services and the Treasury Bureau and the Department of Justice are collaborating closely on the drafting.

15. The Capital Rules are to be made under the new section 98A of the BO (as in section 4 of the BAO 2005) to prescribe the manner in which AIs incorporated in Hong Kong shall calculate their CAR under section 98 of the BO. The Capital Rules are in seven parts, as follows -

- **Part 1** specifies that the rules shall come into operation on a day to be appointed by the Secretary for Financial Services and the Treasury and defines the terms used in the rules.

- **Part 2** specifies the calculation approaches to calculate an AI's credit, operational and market risks and the qualifying criteria for using some of these approaches; the requirement for an AI to calculate its CAR on a solo (or solo-consolidated) basis and/or consolidated basis; and the appeal mechanism and the appealable decisions made by the MA under these Rules.

- **Part 3** specifies how an AI determines its capital base.

- **Parts 4–6** prescribes the methodologies to calculate an AI's credit risk, market risk and operational risk using the various approaches specified in Part 2.

- **Part 7** prescribes the asset securitization framework.

Further details are given in Annex C.

16. Given the length and complexity of the Basel II requirements, the Capital Rules have been prepared in four batches. Preliminary consultation of the industry on the first two batches has already been completed. The first batch concerns Part 4 of the Capital Rules insofar as it relates to the Standardized Approach to the calculation of credit risk and Part 5 of the Capital Rules dealing

with operational risk. Relevant definitions for inclusion in Part 1 of the Capital Rules are also included. The second batch relates to "Application of these Rules" in Part 2, "Determination of Capital Base" in Part 3 and the Basic Approach to calculation of credit risk in Part 4. The latest draft of these two batches of rules are enclosed as Annexes D and E to this paper for Members' reference.

17. Preliminary industry consultation on the third batch of draft rules, relating to the calculation of market risk in Part 6 and asset securitization in Part 7, is currently underway. The consultative draft of this batch is at Annex F for Members' reference. Preliminary industry consultation on the fourth batch of draft rules, covering the IRB Approach to the calculation of credit risk in Part 4 of the Capital Rules, is scheduled to be conducted in May 2006. We will make available to Panel Members copies of the fourth batch of draft rules once they are ready.

18. After the preliminary consultation, the whole set of draft Capital Rules will then be revised for a second round of consultation, the statutory consultation as required under the BAO 2005. The MA is subject to the statutory duty to consult the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, The Hong Kong Association of Banks, the DTC Association and the Financial Secretary when making the Capital Rules and Disclosure Rules. It is expected that the rules will be ready for gazette in September 2006 and tabling before the Legislative Council in early October for negative vetting.

19. The Disclosure Rules will bring the existing disclosure requirements broadly into line with the recommendations of the Pillar 3 framework of Basel II. They are being developed under the guidance of the Working Party on Financial Disclosure[3], the BCG and in consultation with the industry associations. The Rules will replace existing HKMA disclosure guidelines for reporting periods beginning January 2007. It is expected that the drafting of these rules and consultation on these rules can be completed in time for them to be introduced into the Legislative Council at the same time as the Capital Rules. For Members' reference, a policy paper outlining the requirements of the Disclosure Rules is enclosed at Annex G.

Consultation and dialogue with AIs

20. The HKMA has consulted the industry and other interested parties extensively throughout the long process of development of Basel II, the detailed implementation proposals for Hong Kong and the subsequent development of the Capital Rules and Disclosure Rules. There is strong support from the parties consulted, and their comments (which have mainly been of a technical nature) have been taken into account where appropriate in preparing the Rules. Feedback documents detailing major comments received in the consultation

[3] The Working Party on Financial Disclosure includes representatives from AIs, both locally and overseas incorporated, and members of the accounting and audit profession.

process and the HKMA's responses to them were issued to the industry associations and posted on the HKMA's website to facilitate AIs' continuing preparation for implementation of the revised framework.

21. The reporting form for the new CAR requirements together with detailed completion instructions have also been issued for the industry's reference. To enable AIs to become familiar with the new return and to assess the impact of the revised framework on their minimum capital requirement, they will be required to conduct parallel reporting of the existing CAR return and the relevant parts of the new return for certain specified periods this year.

22. Further, the HKMA has maintained a close dialogue with AIs to ensure that they can achieve compliance by the implementation date of January 2007, through bilateral meetings, industry briefing sessions, circulars and feature articles in the HKMA's quarterly bulletins and website. In the case of AIs that are subsidiaries of foreign banking groups, the HKMA will in implementing the Hong Kong framework co-ordinate with the home supervisors of these banking group to eliminate duplication and overlap of efforts.

23. Therefore, despite the lengthy process needed for the preparation of the Capital Rules and Disclosure Rules, we are of the view that sufficient guidance and time have been made available to AIs to prepare for implementation of Basel II.

Establishment of Capital Adequacy Review Tribunal

24. Under the BAO 2005, certain decisions of the MA made under the Capital Rules as specified in those rules are appealable to a tribunal known as the "Capital Adequacy Review Tribunal" (CART). The scope of responsibility of the CART will be limited to reviewing, upon application of aggrieved persons, major decisions of the MA made under the Capital Rules. As stated in the draft Capital Rules, the right of appeal will only lie in respect of the fundamental decision as to which approach to capital adequacy calculation an AI may adopt, which may have a material impact on the AI's capital requirement.

25. The CART, which is to be established towards end-2006, will consist of a chairman, who is 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. The CART is expected to commence operation at the same time as the Capital Rules become effective. Given the HKMA's close dialogue with AIs in their preparation for implementing Basel II (e.g. on their choice of approaches to calculate capital charge), we expect the need for the CART to hear appeals to be minimal.

Way forward

26. So far, the HKMA has made good progress in the implementation of Basel II. AIs are also actively working towards compliance by the implementation date of January 2007 based on the implementation proposals and draft Rules issued to the industry. The HKMA will continue its preparatory work and its dialogue with AIs on their preparations for the implementation.

27. The implementation approach developed for Hong Kong and outlined above is, we believe, pragmatic and cost-effective. The close cooperation with the industry throughout the process has helped ensure that their wishes as regards the timetable for implementation, the available range of options, and the guidance to be issued, have mostly been able to be accommodated. Moreover, we have been very flexible on many aspects of the implementation: we have allowed an extended transition period for those planning to use the more advanced approaches; and have devised a simplified approach for the smaller institutions. And we have tried as much as possible to harmonise our requirements with those of other regulators, so that banks operating in multiple jurisdictions do not face multiple requirements.

28. There is a clear necessity for a timely completion of the legislative process of the Capital Rules and Disclosure Rules. Any delay in the legislative process will affect the target implementation date, and the position of Hong Kong as an international financial centre that prides itself on its commitment to always follow closely international supervisory standards.

Hong Kong Monetary Authority
April 2006

<u>Annex A</u>

Sections 4 and 2 of the Banking (Amendment) Ordinance 2005
(not yet in operation)

4. Section added

The following is added –

"**98A. Calculation of capital adequacy ratio**

(1) The Monetary Authority may, after consultation with the Financial Secretary and the persons specified in subsection (2), make rules prescribing the manner in which the capital adequacy ratio of authorized institutions shall be calculated.

(2) The persons specified for the purposes of subsection (1) are –

(a) the Banking Advisory Committee;
(b) the Deposit-taking Companies Advisory Committee;
(c) The Hong Kong Association of Banks; and
(d) The DTC Association.

(3) Rules made under subsection (1) may provide for the Monetary Authority, on application made to him by an authorized institution aggrieved by a decision of the Monetary Authority made in relation to it under those rules, to review his decision.

(4) Rules made under subsection (1) may provide that a decision made by the Monetary Authority under those rules is a decision to which section 101B(1) applies.

(5) For the avoidance of doubt, it is hereby declared that any requirement under subsection (1) for the Monetary Authority to consult with any person shall not operate to prevent the Monetary Authority from consulting with such other person as the Monetary Authority thinks fit.".

2. Section substituted

Section 60A of the Banking Ordinance (Cap. 155) (as inserted by section 6 of the Banking (Amendment) Ordinance 1999 (42 of 1999) and further amended by section 24(4) of the Banking (Amendment) Ordinance 2001 (32 of 2001)) is repealed and the following substituted –

"**60A. Disclosure to the general public of information relating to financial affairs**

(1) The Monetary Authority may, after consultation with the Financial Secretary and the persons specified in subsection (2), make rules prescribing the information to be disclosed to the general public by authorized institutions relating to their state of affairs, profit and loss or capital adequacy ratio and prescribing the manner in which, times at which and periods during which such information shall be so disclosed.

(2) The persons specified for the purposes of subsection (1) are –

(a) the Banking Advisory Committee;
(b) the Deposit-taking Companies Advisory Committee;
(c) The Hong Kong Association of Banks; and
(d) The DTC Association.

(3) Rules made under subsection (1) may make different provision for

authorized institutions belonging to different classes of authorized institution.

(4) Where an authorized institution fails to comply with any requirement applicable to it contained in rules made under subsection (1), every director, every chief executive and every manager of the authorized institution commits an offence and is liable –

(a) on conviction upon indictment to a fine at tier 7; or

(b) on summary conviction to a fine at tier 5,

and, in the case of a continuing offence, to a further fine at tier 2 for every day during which the offence continues.

(5) For the avoidance of doubt, it is hereby declared that any requirement under subsection (1) for the Monetary Authority to consult with any person shall not operate to prevent the Monetary Authority from consulting with such other person as the Monetary Authority thinks fit.”.

Annex B

Basic features of Basel II

1. Basel II consists of three mutually reinforcing "pillars" that are designed to allow both banks and their supervisors to properly evaluate the various risks faced by banks. The Capital Rules will cover matters falling within pillar 1 and the Disclosure Rules will cover matters falling within pillar 3.

(I) Pillar 1 – Minimum Capital Requirements

2. This pillar prescribes how the minimum CAR is to be calculated for a bank's exposure to credit risk, operational risk and market risk and offers different approaches to the calculation of capital requirements.

3. The HKMA considers it appropriate, in view of the widely differing business focus, size and complexity of AIs and the nature and combination of risks which they face, to allow AIs a measure of flexibility in selecting the approaches to be adopted under pillar 1. The following three options will be available in Hong Kong for calculating the minimum capital requirement for credit risk -

3.1 Basic Approach – it is anticipated that this will mostly be adopted by the smaller AIs (i.e. restricted licence banks and deposit-taking companies whose total assets fall below HK$10 billion). This option will allow them to use the current capital framework for risk-weighting all credit exposures, subject to a few technical adjustments and the imposition of a capital charge for operational risk, so as to align more closely with Basel II;

3.2 Internal Ratings-based (IRB) Approach – it is anticipated that this will mostly be adopted by larger AIs. AIs will be able to rely on their own internal rating systems for assessments of credit risk in order to calculate the capital which they must hold, provided that they can satisfy their supervisors that their systems meet a set of minimum supervisory standards. Depending on the level of sophistication of their internal rating systems, AIs may choose from a range of approaches available under the IRB framework for different types of asset class or exposure. This option will allow AIs to use the Foundation or Advanced IRB Approach for sovereign, bank or corporate exposures and other available IRB approaches applicable to different types of asset class or exposure; and

3.3 Standardized Approach – it is anticipated that this option will be adopted by medium sized AIs. This is conceptually similar to the current capital framework. However, the classification of AIs' counterparties and of assets and other items in AIs' business portfolios and the determination of risk-weightings applicable to them are more risk-sensitive. Credit exposures to various types of counterparty, e.g. sovereigns, banks and corporates, will be assigned different risk-weightings based upon assessments by recognised external credit assessment institutions (such as Moody's Investors Service, Inc. and Standard & Poor's Corporation). This option will require the use of the Standardized Approach for the risk-weighting of all credit exposures.

4. Under Basel II, capital is explicitly required to be held by banks to cover operational risk**,** which is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people or systems or from external events. Basel II incorporates three options for the calculation of operational risk: Basic Indicator Approach, Standardized Approach and Advanced Measurement Approaches. The HKMA's policy in Hong Kong is that only the Basic Indicator Approach and the Standardized Approach (including an Alternative Standardized Approach which is provided for in a footnote on page 139 of Basel II), will initially be available for AIs. The Alternative Standardized Approach is similar to the Standardized Approach save that it provides for slightly different treatment for commercial banking and retail banking business lines. AIs intending to use the Standardized Approach (or Alternative Standardized Approach) will need to seek the prior approval of the MA. Techniques to be used in respect of the Advanced Measurement Approaches are still evolving and so, initially at least, these Approaches will not be available to AIs.

5. The principles and rules for calculating the market risk capital requirement were introduced by the Basel Committee in 1996 in an amendment to the 1988 Basel Accord. Capital requirements are prescribed for an AI's "trading book", consisting of positions in financial instruments and commodities, using either the Standardized Approach (based on a standardized framework set by the Basel Committee for less sophisticated banks) or, subject to supervisory approval of the model, the Internal Models Approach (for active market participants who have developed sophisticated model based systems for measuring market risks) subject to a de minimis exemption for AIs with insignificant market risk exposures. These principles and rules remain largely unchanged under Basel II, except for some refinements such as changes in the definitions of what constitutes a "trading book" and the use of external credit ratings for determining the risk-weight for debt securities issued by central governments or central banks or monetary authorities.

(II) Pillar 2 – Supervisory Review Process

6. This pillar sets out key requirements applicable to both banking supervisors and banks with a view to ensuring that, through the supervisory review process, banks will not only have adequate capital to support the risks inherent in their business but will also be encouraged to develop and use improved risk management techniques in monitoring and managing these risks. The key elements of pillar 2 include:-

6.1 banks to assess and maintain capital in relation to their individual risk profile;

6.2 banking supervisors to ensure compliance with paragraph 6.1 and take supervisory action if necessary;

6.3 banking supervisors to ensure banks operate above minimum CARs; and

6.4 banking supervisors to intervene and require prompt remedial action at an early stage to prevent capital falling below minimum levels.

(III) Pillar 3 – Market Discipline

7. This pillar is to complement pillars 1 and 2 by encouraging market discipline through the public disclosure of key information on risk exposures and capital adequacy. The BO currently provides in section 60 for the public disclosure of AIs' audited annual accounts. In addition, a new section 60A of the BO (inserted by section 2 of the BAO 2005) empowers the MA to require public disclosure of information relating to the state of affairs, profit and loss or CAR of AIs.

Annex C

Structure of the Rules

1. It is currently envisaged that the Capital Rules will be divided into 7 parts as follows:-

Part 1 – Preliminary
- Purpose of the Capital Rules
- Interpretation

Part 2 – Application of These Rules
- Prescribed calculation approaches
- Qualifying criteria for the use of calculation approaches
- Solo, solo-consolidated and consolidated bases for calculation of capital adequacy ratio
- Appeals

Part 3 – Determination of Capital Base
- Core Capital
- Supplementary Capital
- Deductions from Core and Supplementary Capital

Part 4 – Calculation of Credit Risk
- Application
- Calculation of credit risk under Standardized Approach
- Calculation of credit risk under Basic Approach

Part 5 – Calculation of Operational Risk
- Basic Indicator Approach to calculation of operational risk
- Standardized Approach to calculation of operational risk
- Alternative Standardized Approach to calculation of operational risk
- Exceptions

Part 6 – Calculation of Market Risk

Part 7 – Asset Securitization

2. However, once a full draft of all of the Capital Rules is available, consideration will be given as to whether it is necessary to have a separate part of the Rules for each calculation approach (e.g. for Credit Risk a separate part for the Basic Approach, the Standardized Approach and the IRB Approach).

3. It is currently envisaged that the Disclosure Rules will be divided into 9 parts as follows:

Part 1 – Preliminary

Part 2 – General Principles

Part 3 – General Requirements

Part 4 – Disclosures Applicable to all Hong Kong Incorporated Authorized Institutions

Part 5 – Additional Disclosures specific to Hong Kong Incorporated Authorized Institutions under the Basic Approach

Part 6 – Additional Disclosures specific to Hong Kong Incorporated Authorized Institutions under the Standardized Approach

Part 7 – Additional Disclosures specific to Hong Kong Incorporated Authorized Institutions under the Foundation or Advanced Internal-Ratings Based Approach

Part 8 – Half Yearly Disclosures by Overseas Incorporated Authorized Institutions

Part 9 – Implementation and Transitional Provisions