Implementation of Basel II in Hong Kong

by the Banking Policy Department

The article entitled "Implementation of Basel II in Hong Kong" published in the September issue set out an overview of the HKMA's approach and work progress in various key areas of the revised capital-adequacy framework under Basel II. Further to that article, this memo aims to help authorized institutions (AIs) incorporated in Hong Kong prepare for the implementation of the revised framework in Hong Kong. The memo sets out the policy stance of the HKMA through a number of commonly asked questions about the implementation.

Q.1 How should AIs prepare for implementing the revised framework in January 2007?

A.1 The HKMA expects AIs to have a thorough understanding of its detailed proposals, and to continue to carry out their implementation plan according to their choices of approach under the revised framework. For the purposes of calculating credit-risk capital requirement, the HKMA expects AIs to take account of the following in their implementation process to ensure compliance with the chosen approach.

- **Basic Approach users** - to understand the modifications to the existing framework and ensure that their internal systems are suitably upgraded.

- **Standardised Approach users** - to ensure adequate system capabilities are in place to support an external ratings-based framework for risk-weighting exposures. Certain required standards and procedures are to be followed according to an AI's choice of external rating institutions, the ratings assigned by which the AI will apply to derive the risk weights for its credit exposures. These standards and procedures are described in Q.4 and Q.5. AIs will also need to modify their internal systems for other important definitional changes from the existing framework, such as those related to "residential mortgage loans" qualified for preferential risk-weighting.

- **Internal Ratings-Based (IRB) Approach users** - to continue to work towards complying with the necessary system and data requirements, having regard to their on-going self-assessment and target implementation schedules. As part of the approval process, AIs should continue to keep the HKMA informed and discuss with the HKMA when they are ready for system recognition.

Apart from credit-risk capital requirement, there are other areas of the revised framework applicable to all AIs that require system changes. These include the additional operational-risk capital charge as well as the Pillar 2 and Pillar 3 requirements. For calculating operational-risk capital charge, AIs may choose among a number of approaches. AIs are expected to notify or seek the approval of the HKMA regarding their choices of approach (see Q.3) as in the case of credit risk.

Q.2 Are AIs expected to participate in the parallel reporting regardless of the approaches they adopt under the revised capital adequacy framework? What will the new Capital Adequacy Ratio (CAR) return look like and which parts will be covered in the parallel reporting?

A.2 Reflecting the menu-based approach to accommodate AIs that intend to adopt different approaches to capital calculation, the new CAR return will consist of various parts, some of which are further divided into different forms for different approaches. For instance, the part on credit risk will be divided into reporting forms in relation to the Basic Approach, the Standardised Approach and the IRB Approach. Other parts of the new return will be related to capital base, market risk (which will be largely similar to the existing return of market-risk exposures), operational risk and asset securitisation. AIs will only need to complete the parts applicable to them.

AIs will be required to simultaneously report the new and the existing CAR returns for a certain period prior to their formal submission of the first new return, so that they can familiarise themselves with the new return and ensure that they maintain sufficient regulatory capital under the revised framework. The parallel reporting will, for AIs using the Basic Approach and the Standardised Approach, cover the positions of September and December 2006, and for those using the IRB Approaches, the four quarters prior to implementation. This means that those Foundation IRB users implementing the revised framework in January 2007 will report the positions of March, June, September and December 2006, and those Advanced IRB users implementing the revised framework in January 2008 will report the positions of March, June, September and December 2007. AIs, regardless of the approach they intend to use for calculating credit-risk capital requirement, are required to include the parts of the return on operational risk and where applicable, market risk in the parallel reporting for the positions of September and December 2006.

The HKMA will provide further guidance to the banking industry in relation to the reporting of the new return when various parts of it are released for consultation towards the end of 2005.

Q.3 The HKMA requires AIs to seek its approval using the Standardised Approach (SA) or Alternative Standardised Approach (ASA) to calculate capital requirements for operational risk. Will there be any special template or application pack for AIs to submit their applications? What guidance can AIs refer to in considering their eligibility for these approaches?

A.3 The HKMA has previously issued proposals on the relevant risk-weighting framework for operational risk based on Basel II. Industry consultation on these proposals has been completed. The HKMA has not received any major comments. The HKMA subsequently issued a Supervisory Policy Manual (SPM) module on operational risk management in November and is now transforming the proposals on the risk-weighting framework into Capital Rules for further consultation.

SA or ASA aspirants will need to consider whether they can meet the specific qualifying criteria set out in the HKMA's implementation proposals as well as the guidance in the SPM module, and seek the HKMA's approval for using the approaches. The HKMA does not intend to prescribe any template or application pack. To demonstrate that they meet all the relevant qualifying criteria, AIs should provide the HKMA with a brief description of their existing operational risk-management framework and information on their operational risk-management policy and arrangements in the applications. Verification of compliance with the relevant qualifying criteria, while not necessarily being part of the approval, may be covered in a subsequent on-site examination of the AI.

Q.4 Under the HKMA's implementation proposals on the Standardised Approach for credit risk, the ratings of Moody's Investors Service, Inc, Standard and Poor's Corporation and Fitch Ratings Ltd have already been mapped to the respective risk-weights. Does this imply that these three external credit-assessment institutions (ECAIs) have already been recognised by the HKMA for determining the risk-weights of AIs' credit exposures?

A.4 The mappings shown in our proposals are for illustration purposes only. In December 2005, the HKMA issued a consultation paper about the recognition of ECAIs for the purposes of Basel II, including the eligibility criteria for recognition. Moody's Investors Service, Inc, Standard and Poor's Corporation, Fitch Ratings Ltd, as well as the Rating and Investment Information Inc., have already been recognised by the HKMA for the purposes of liquidity ratio and market-risk capital requirements. The HKMA will determine whether they can also be recognised for Basel II purposes by updating its assessments of these institutions based on the proposed eligibility criteria. The HKMA aims to complete the recognition and mapping process for these ECAIs in the first quarter of 2006. This will provide the necessary clarity for AIs that will be subject to the Standardised Approach.

AIs intending to use the ratings of other ECAIs should notify the HKMA so that the HKMA may consider the eligibility of those ECAIs.

Q.5 According to Basel II, AIs must use the ratings of their chosen ECAIs consistently in risk-weighting each type of claim under the Standardised Approach. Could the HKMA elaborate on how this requirement will be implemented?

A.5 The main purposes of this requirement are to ensure that AIs apply the ratings of its chosen ECAIs consistently, and to avoid any possible cherry-picking of ratings provided by different ECAIs.

AIs should first decide which ECAIs' ratings are to be used. They should ensure that their chosen ECAIs can provide a reasonable rating coverage of their exposures within the portfolios in terms of types of counterparties and geographical regions, having regard to other ECAIs recognised by the HKMA. The AIs should then notify the HKMA of their choice of ECAIs and the manner in which the ECAIs' ratings are applied in each of their external ratings-based portfolios, and use the ratings of the chosen ECAIs consistently.

Q.6 When will the HKMA conduct the IRB recognition process for AIs that plan to adopt the Foundation IRB or Advanced IRB Approach?

A.6 The timing for IRB recognition is largely determined by the year of IRB implementation (both for FIRB and AIRB) proposed by an AI. As a general rule, the recognition process (including on-site examination) for an AI will take place the year before it starts the parallel reporting, and the process will last three to six months. The exact schedule will be subject to the number of AIs adopting the IRB Approaches in a given year, and the HKMA will notify individual AIs about the schedule as soon as possible.

Q.7 How will the HKMA conduct the supervisory review process (SRP) under Pillar 2? Will the result of the review have an impact on the minimum CAR set for each AI?

A.7 The main elements of Pillar 2 are already embedded in the HKMA's existing supervisory approach, which provides a good basis for conducting the SRP. The implementation of Pillar 2 in Hong Kong will be more of an elaboration and refinement process rather than a radical change of the existing practices.

Under Pillar 2, the HKMA will continue to set the minimum CAR of individual AIs. However, the setting of minimum CAR will be based on a more detailed and rigorous assessment process taking into account the AIs' overall risk profile and management systems, the extent to which they are exposed to risks not covered under Pillar 1, and their ability to conduct capital adequacy assessments. The HKMA will soon be issuing a consultation paper to set out the proposed approach and framework for conducting the SRP. Under the SRP, AIs are encouraged to develop and strengthen their systems and capabilities for undertaking a capital adequacy assessment process (CAAP) that fits their own needs, including their ability to conduct stress tests for assessing capital requirements. As the development of a CAAP is a continuing process, the HKMA does not intend to set a rigid timetable for AIs to meet the relevant supervisory standards. When an AI's CAAP becomes more established, the HKMA will rely more on the results of the CAAP in setting the minimum CAR.

After the completion of a Pillar 2 review, the HKMA will discuss with the AI concerned the results of its assessment, particularly any areas of concern which may lead to an increase in the AI's minimum CAR. The HKMA will explain to the AI the factors leading to the assessment conclusion and recommend the actions needed to address the concerns.

Q.8 What is the implementation timetable for Pillar 3 disclosures? How will the HKMA's required disclosures relate to those required under the new accounting standards?

A.8 The HKMA is preparing to revise its existing disclosure requirements to bring them broadly into line with those recommended by the Basel Committee under Pillar 3 of Basel II. AIs will need to comply with the revised disclosure requirements promulgated by the HKMA under the Disclosure Rules starting from 1 January 2007 (therefore, the first reporting date under the revised disclosure framework will be June 2007).

In developing its proposals, the HKMA will take into account the fact that a number of the regulatory disclosure requirements under Pillar 3 have already been substantially covered by the disclosure requirements of IFRS (International Financial Reporting Standards) 7 *Financial Instruments: Disclosure*. Because IFRS 7 is meant to give the readers of financial statements a clear picture about an entity's use of financial instruments and the risks of these financial instruments, and to ensure that the entity's capital is conducive to market discipline, the HKMA regards these objectives as broadly in line with the main target of Pillar 3. Therefore, to avoid unnecessary duplication of AIs' disclosures, the HKMA will regard the compliance with the accounting standards as compliance with the Pillar 3 disclosure requirements. The HKMA plans to consult the banking industry and other interested parties on this subject in the first quarter of 2006.