Basel II
Practical Implementation Issues

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Outline of Presentation

• Should we implement?
• Which approaches?
• When?
• Prioritisation of the different elements of Basel II
• Foundations / preconditions for implementation
• Readiness of supervisory authorities and banking institutions
• Practical implementation issues
• Cross-border issues
• Hong Kong approach
Should We Implement?

• Is Basel II good for me and my country?
• Should we implement Basel II in our country?
• What may others think if we do not implement Basel II?
  – Will there be pressure from foreign banks?
  – Will there be pressure from inside my organisation?
  – If we do not comply with Basel II, will this influence the next FSAP?
• Will foreign banks turn their subsidiaries into branches?
Which Approaches?

• Approaches for credit risk
  – Simplified standardised approach
  – Standardised approach
  – Foundation internal ratings-based approach
  – Advanced internal ratings-based approach

• Approach for operational risk
  – Basic Indicator approach
  – Standardised approach
  – Alternative standardised approach
  – Advanced measurement approaches

• There is no “one way” to implement Basel II
When?

**Basel II Framework (June 2004)**

“This document is being circulated to supervisory authorities worldwide with a view to encouraging them to consider adopting this revised Framework *at such time as they believe is consistent with their broader supervisory priorities.*”
Big banks urge emerging markets to move quickly…

- IIF Steering Committee on Regulatory Capital (Nov 2005)
  …member banks believe that, as soon as reasonably possible, they and their local jurisdictions should aim to take advantage of … the Internal Ratings Based (IRB) Approaches.

…but the IMF board cautions against moving too quickly…

- IMF Executive Board (Nov 2005)
  (The Directors) urged staff to be completely candid when asked to assess countries’ readiness to move to Basel II and to indicate clearly the risks of moving too quickly and too ambitiously.
When?

• When should Basel II be implemented?
  – Only national authorities can answer this question
  – Basel II may be a lesser priority compared to other efforts
• Depending on a bank’s business, the 1988 Accord may remain an alternative
  – But principles of Basel II are valuable for supervisors and banks in all markets
• In their assessments of a country’s compliance with Core Principle 6 the IMF and the World Bank will not assess compliance based on whether or not a country has implemented Basel II. (IMF staff note, 23 April 2004)
What is Required to Implement Basel II?

- Implementing Basel II will be a major challenge for banks and supervisors
- Assessing resource and training needs
  - Human resources
  - Financial resources
  - Information systems
- FSI providing support through seminars and FSI Connect
- Ongoing communication between supervisors and between supervisors and banks
Solid Foundation

- A solid foundation is essential for building a road
- Basel II requires an appropriate infrastructure
  - Otherwise there could be a false sense of financial stability
- Preconditions for core principles are fundamental
- Compliance with Core Principles is crucial
  - System of effective supervision must exist in a country
  - Sound accounting and provisioning standards
Readiness on Regulators’ Side

- Control over bank’s structure
  - Licensing
  - Ownership
  - Activities, acquisitions

- Risk management and capital
  - Provisioning
  - Large exposure
  - Related party exposure
  - Liquidity

- Banks’ internal control and governance
- Account- ing and disclosure
- On-site, off-site monitoring
  - Remedial actions
  - Consolidated supervision
  - Home-host cooperation

- Institutional setting of the supervisor
  - Independence, governance, accountability, transparency
  - Resources, legal power

- Preconditions
  - Sound macro-economic policies
  - Legal, accounting, auditing and payment systems
  - Systemic protection
Practical Implementation Issues

- Transform the framework into enforceable rules
- Implementation
  - Minimum capital ratio – is 8% enough (the speed limit)
  - Deciding on the use of national discretion
  - Accord Implementation Group
  - Determining the scope of application of Basel II
- Paper on “practical considerations” published in July 2004
  - Intended as a “roadmap” for implementation
Areas of National Discretion

• Recognises countries‘ different realities
• Essential part to ensure that the implementation is to be a success
• Supervisors should develop policy decisions on the whole range of issues (Annex of „practical considerations paper“)
  – Draw upon domestic market practice and experience
  – Be consistent with the Basel II principles
• Share information with other supervisors
Cross-Border Implementation

• Challenge because of how banks are organised
• Must respect home and host jurisdiction
• But must strive for a higher degree of communication, coordination and cooperation than generally the case now
• Hosts and homes should try to coordinate information requests where possible
Cross-Border Implementation

- Hosts need to think about what information they would need to enhance their ability and willingness to rely on home (e.g. validation)
- Subsidiaries must satisfy supervisory and legal requirements of the host jurisdiction
- Variety of ways for homes and hosts to enhance interaction
- Supervisors should communicate plans to banks
Cross-Border Implementation

Committee has provided guidance:

- Home-host information sharing for effective Basel II implementation (November 2005)
- Enhanced cross-border cooperation (May 2004 press release)
- Principles for the home-host recognition of the advanced measurement approaches in operational risk (January 2004)
- High-level principles for cross-border implementation (August 2003)
The Hong Kong Experience

Questions to ask yourself…

• Should we implement? If so, when? What options should we offer? Should all institutions be covered?
• What legislation is needed? What supplementary supervisory guidelines are needed?
• How will the supervisory process be affected? Are we ready for true “risk-based supervision”?
• Do we have the necessary skill-sets within the institution? Do we need models experts? Will our staff be able to adapt?
Should We implement? If So, When? What Options Should We Offer? Should All Institutions be Covered?

• In Hong Kong we decided early on
  – to implement Basel II;
  – to do it at the same time as the Basel Committee member jurisdictions;
  – to offer IRB as well as standardised approach (but not AMA);
  – and to apply it to all institutions.

• In addition, a simpler (“basic”) approach to credit risk has been developed which is more suited to smaller institutions.
Hong Kong’s “Basic” Approach

- Target users:
  - Smaller institutions (assets below HK$ 10bn)

- Treatment of credit risk largely as per Basel I, with minimal number of changes where alignment with standardised approach is desirable
  - Tier 1/Tier 2 (i.e. OECD/non-OECD) split retained for sovereigns, PSEs, banks & corporates
  - 50% weighting for RMLs retained (but definition revised)
Hong Kong’s “Basic” Approach

- Some changes to definition/treatment of certain off-balance sheet exposures (e.g. commitments, CCF for credit derivatives, repos)
- Users of the Approach are subject to operational risk capital charge and relevant Pillar 2 and 3 requirements
Should We implement? If So, When?
What Options Should We Offer? Should All Institutions be Covered?

- Institutions are given the choice as to which approaches they adopt and, in particular, are not mandated to adopt IRB (“no compulsion / no prohibition”)
- There is flexibility on the timing of adoption of IRB and an extended transitional period, to accommodate international banking groups’ global implementation plans
Hong Kong Implementation Timeline

- Jan 2007
  - Credit risk: standardised approach: 20 or so
    basic approach: 50 or so
    foundation IRB: 1 or 2
  - Operational risk: basic indicator approach: 50 or so
    standardised approach: 20 or so
    alternative standardised approach: 1 or 2
  - Market risk: standardised approach 35 or so
    internal models approach 4 or 5
Hong Kong Implementation Timeline

- Jan 2008 (onwards)
  - Advanced IRB introduced
  - 7 or 8 AIs may transition from basic or standardised approach to foundation or advanced IRB
What Legislation is Needed? What Supplementary Supervisory Guidelines Are Needed?

• Jurisdictions’ readiness in terms of legislation also varies widely. In Hong Kong we initiated the process of updating the legislation early, but it has proved to be a long and difficult process.

• Rather than putting every detail of the computation of capital in the legislation, we opted for a “rule-making approach” whereby we will set out in formal rules the nitty-gritty details.

• Jurisdictions which have such an approach have more flexibility, and can make changes more easily and quickly.
What Legislation is Needed? What Supplementary Supervisory Guidelines Are Needed?

• We have completed the process of designing new report forms for capital adequacy, and our IT Department are making the necessary changes to the IT systems. The parallel run commences for the end-Sep 2006 returns. Next stage is to re-design our internal MIS on capital adequacy.

• We are also well advanced on issuing supplementary supervisory guidelines, e.g. on operational risk, stress-testing, etc.

• Other areas on which there is a knock-on effect include large exposures, collateral, market risk...
How Will the Supervisory Process Be Affected? Are We Ready For True “Risk-based Supervision”? 

• It becomes clear as you get into your Basel II implementation that it will have a profound effect on the supervisory process.

• In particular, given the heavily “risk-based” focus of Basel II, jurisdictions need to have in place an effective system of risk-based supervision in order to be able to adapt to the different demands Basel II will place on them as compared with Basel I.
How Will the Supervisory Process Be Affected? Are We Ready For True “Risk-based Supervision”?

• Given that different types of institutions will adopt different approaches to capital calculation (e.g. standardised / IRB), the supervisory system needs to be more flexible than before.

• More emphasis needs to be placed on verifying that systems and controls, and in particular risk management, are adequate, rather than on checking compliance with prudential norms.
Do We Have The Necessary Skill-sets Within The Institution? Do We Need Models Experts? Can Our Staff Adapt?

• In the HKMA we have largely used experienced bank supervisors in our Basel II implementation, although we have brought in a couple of models experts.

• We have also spent a lot of time on training, although even now this still needs to be intensified.

• The best way of inculcating into staff the Basel II culture, we have found, is to involve all supervisory staff in the Basel II process, rather than treating it as a narrow “policy issue”.

• Staff retention is, however, an issue (as there is competition from the private sector for Basel II skills).
Conclusions

• The approach to be adopted and the timing of implementation will vary among jurisdictions, depending on the local situation, on the readiness of the supervisory authorities and the banks, and on national priorities.

• Implementing Basel II is not a race; nor is it necessary or appropriate for all to aspire to the advanced approaches. IRB may not be appropriate; standardised approach, or a simplified standardised (or “basic”) approach may be perfectly fine.

• Consideration can be given to implementing elements of Pillars 2 and 3 ahead of implementation of Pillar 1.
Conclusions

• Implementation is very challenging, and requires long-term planning and commitment – but we can all learn from each other and thereby make the task more manageable and perhaps a little less daunting

• Extensive information on Basel II implementation in Hong Kong is available on the Hong Kong Monetary Authority’s website at www.hkma.gov.hk (N.B. there is a separate icon for Basel II under “Policy Areas”)

• Fellow supervisors are welcome to make use of these materials as they wish