

Box 4.1**Key features of Basel II and its benefits to the economy**

The Basel Committee on Banking Supervision, established by the central bank governors of the Group of Ten countries, released the revised capital adequacy framework (commonly referred to as “Basel II”) in June 2004. The objective of Basel II is to better align minimum capital requirement of banks more closely to the risks they face. The revised framework replaces the old “one size fits all” approach on banks in regard to risk management. Given the significant benefits of Basel II to the Hong Kong economy, Hong Kong has been at the forefront of jurisdictions globally taking active steps to incorporate the requirements of the revised framework into their regulatory regimes.

The revised framework under Basel II adopts a three-pillar structure which represents a major step forward in terms of the identification, quantification and management of risk and public disclosure.

Pillar 1 requires banks to maintain a minimum amount of capital for credit, market and operational risks. The new framework provides a spectrum of approaches for banks of different levels of sophistication, depending on their internal risk management capabilities and complexity of operations, to calculate their minimum capital requirement.

Pillar 2 requires banks to assess the full range of risks they run and to determine how much capital to hold against them. The banks’ capital adequacy and internal assessment process will also be reviewed for ensuring that capital above the minimum level is held where appropriate.

Pillar 3 aims to bolster market discipline by setting out the disclosure requirements applicable to banks in areas such as their risk profiles, capital adequacy and internal risk management. As a general rule, different banks with different levels of sophistication and risk exposures will be subject to different disclosure requirements.

Hong Kong has implemented Basel I and its subsequent amendments. As an international financial centre that prides itself on adopting best practices that commands wide international acceptance, Hong Kong has committed to adopting Basel II. Implementation of Basel II in Hong Kong will commence in phases starting on 1 January 2007. This is in accordance with the timetable recommended by the Basel Committee for its own members, and will be at about the same time as other major international financial centres, such as London, Frankfurt and Tokyo, and also broadly similar to that of Australia and Singapore.

Recognizing that banks in Hong Kong vary widely in terms of their business focus, size and complexity, as well as the nature and combination of risks they face, the HKMA will adopt a menu-based approach in implementing Basel II. Banks are expected to choose options based on their risk profile and complexity of operations, and the results of their own detailed feasibility studies and cost-and-benefit analyses.

Basel II will provide incentives to banks to adopt the latest advances in the field of risk management. Banks which adopt best practices in the management of risk will be awarded with lower capital requirements. Enhanced risk management will improve banks’ ability to offer more sophisticated products to customers, thereby helping bolster development of the banking industry. It will also enhance banks’ ability to assess lending to sectors such as the small and medium-sized enterprises, and allow for better risk-adjusted pricing. From a macro perspective, 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, strengthening the position of Hong Kong as an international centre.