

24th ABA General Meeting and Seminar - Special Session (1st November, 2007)

Topic

Base II : Implementation Issues and Concerns

Moderator

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Speakers

Mr. Johnny C.D. Mao - A Banker's Practical Experience

Mr. Peter P.T. Li - A Consultant's Point of View

Basel II: Implementation Issues and Concerns

**Briefing from Mr. Johnny C.D.Mao
(Chief Risk Officer, Bank of East Asia)
- A Banker's Practical Experience**

Basel II: Implementation Issues and Concerns

Topics

- 1) Basel II Implementation in Hong Kong
- 2) BEA's Preparation of Basel II
- 3) Maximizing Enterprise-wide Business Performance
- 4) Basel II : Risk Management and Value Creation
- 5) The Challenges
- 6) Embedding New Culture

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Basel II Implementation in Hong Kong

Basel II Implementation in Hong Kong

Basel II Implementation in Hong Kong

- Hong Kong is among the first batch of countries in adopting Basel II standards from the beginning of 2007.
- Coordination by the Hong Kong Monetary Authority (HKMA)
- Legislative changes and Supervisory Policy Manual before 2007

Basel II Implementation in Hong Kong

Implementation Approaches

- Banks have choices of implementation approach under Basel II
- Approval from HKMA is required for advanced approaches
- Before approval, banks are required to calculate and report capital requirement by using basic approaches under Basel II during the interim period.

Basel II Implementation in Hong Kong

Parallel CAR Reporting

- Banks that target to adopt advanced approaches should prepare for CAR reporting
- HKMA requires banks to report CAR based on both the target advanced approaches and the interim basic approaches for 4 consecutive quarters preceding implementation of the advanced approaches
- Helps the banks to well prepare and identify possible errors

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BEA's Preparation of Basel II

BEA's Preparation of Basel II

BEA's Basel Project

- Back in the first quarter of 2003, BEA has already set up a Steering Committee to deal with this issue
- The chairman of the Steering Committee is Dr. David K.P. Li who is also the Chairman and Chief Executive of BEA.

BEA's Preparation of Basel II

Target Approaches for 3 Risk Areas

- In the 4th quarter of 2003, the Board had approved the implementation plan of the Basel Project

- Target Approaches:-
 - a. Foundation IRB (Internal Ratings-Based) Approach for Credit Risk
 - b. Internal Model Approach for Market Risk
 - c. Standardized Approach for Operational Risk

BEA's Preparation of Basel II

Objectives of Basel Project

- to enhance risk management in a systematic and consistent manner;
- to maximize the risk-adjusted return and shareholder's value;
- to address the requirements under the Basel II

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**Maximizing Enterprise-wide
Business Performance**

Maximizing Enterprise-wide Business Performance

Maximizing Business Performance

- **Global Competition**
- **All enterprises have one goal: survive and become better**
- **To maximize the enterprise's business performance quickly and successfully**

Maximizing Enterprise-wide Business Performance

A Banker's Perspective

Maximizing a bank's business performance or enhancing shareholder's value:-

- effectively identify and manage risk
- efficiently allocate resources and capital
- implement risk-based pricing
- effectively comply with regulator's guidelines
- better credit rating for cheaper capital

Maximizing Enterprise-wide Business Performance

The Challenge

Many approaches of maximizing a bank's performance are available but have challenge:-

- get them all done in a systematical manner
- without competing for resources
- get the support from the bank inside
- recognized by the regulator and the market

Maximizing Enterprise-wide Business Performance

Basel II

- **Basel II = New Concepts?**
- **Operational risk is a good example**
- **Basel II = A consistent framework which allows banks to tackle risk management issues more systematically and tie them up to the capital**
- **To staff : Increased awareness of risk management**
- **To senior management: Increased incentive to allocate resources**

Maximizing Enterprise-wide Business Performance

Compliance vs. Opportunity

Basel II is not a compliance issue only.

Basel II is an opportunity for banks to maximize business performance:-

- **Pool up resources**
- **Focus staff's attention**
- **Create value systematically**
- **Obtain support from regulators**

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**Basel II: Risk Management and
Value Creation**

Basel II: Risk Management and Value Creation

Value Creation

- Basel II creates value for bank's shareholders or customers and enhances bank performance
- Depends on the approaches that a bank will adopt
- Advanced approaches bring in benefits for both shareholder and customer

Basel II: Risk Management and Value Creation

Effective Allocation of Resources

- “Risk” being quantified under IRB Approach and Internal Model Approach
- Probability of Default, Expected Loss, Value-at-Risk
- Risk ranking = Resources Allocation
- Allocate capital resources according to risk appetite
- Allocate human resources for monitoring high-risk portfolio or functional units
- Effective resource allocation = minimize cost

Basel II: Risk Management and Value Creation

Risk-based Pricing

- Pricing is another important factor to achieve a better cost-to-income ratio
- Quantified risk measurement allows all parties to understand risk on the same basis
- Quantified risk measurement allows risk-based pricing
- Benefit to customer (Good quality deserves better pricing)
- Benefit to bank (Risk vs. Return)

Basel II: Risk Management and Value Creation

Business Performance Measurement

- Maximize business performance requires accurate measurement of performance
- Measure by bottom-line result may subject to risk
- Quantified risk measurement can be used to adjust return
- “Risk-adjusted” return can be used as additional reference for performance measurement

Basel II: Risk Management and Value Creation

Market Perception

- One way to create value for shareholder is improving market perception on the bank
- The bank aims at improving risk management by adopting advanced approaches is a good indication
- Pillar 3 disclosure requirements increase transparency of banks' disclosed information
- Without knowing more about the bank, the market will not have confidence

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The Challenges

The Challenges

Prepare for Challenges

- **Basel II is an opportunity for value creation, but also has many challenges**
- **Banks which adopt advanced approaches should be well prepared to face challenges**

The Challenges

Insufficient Data

- Develop good credit rating model requires sufficient data (e.g. default data)
- Insufficient/ inaccurate data creates obstacles for model development
- Early preparation of data collection is necessary no matter which approach a bank adopts

The Challenges

Heavy Investment Cost

- Additional human and capital resources incur heavy cost
- Long-term and gradual benefit
- Immediate impact on bank's bottom-line
- Parties concerned: the Board, senior management, shareholders, rating agencies
- Requires long-term vision

The Challenges

Insufficient Staff Expertise

- Hong Kong is among the first batch of countries to adopt Basel II
- Difficult to find enough human resources with expertise

The Challenges

Basel II Implementation for International Banks

- Different overseas subsidiaries apply for Basel II implementation in different regions
- Regulators' reviews are resources and time consuming
- Different regulators' requirements will duplicate banks' effort and become burden
- Lack of coordination of home-host supervision may become significant burden to banks

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Embedding New Culture

Embedding New Culture

Changes

Banks need to make a lot of changes to tackle the challenges:-

- Example: Change of work procedure for data collection**
- Example: Change of internal control from “passive compliance” to “Pro-active disclosure & self-assessment”**

Embedding New Culture

New Culture

- Changes require new culture and mindset
- Not easy to change a corporate culture
- Communication and transparency can help getting “buy-in”
- To minimize the negative response, purpose and advantage of the changes should be well aware of by the parties concerned

Embedding New Culture

Overriding Mechanism

- Staff should understand that using model not equals abandoning their professional judgement
- Model accuracy is limited initially but banks should still use it as reference and increase the reliance when the model becomes mature
- Overriding mechanism should be in place and reviewed regularly

Embedding New Culture

Training

- Providing sufficient training to staff is also important
- Knowledge transfer from system vendor is one possible solution
- Building up own expertise to monitor and maintain the systems

Embedding New Culture

Home-host Coordination of Supervision

- Communication with regulators is important
- Successful global implementation of advanced approaches, “Home-host” coordination is a key issue
- Banks should proactively communicate with regulators, both home & host
- Work out cost effective solution which can benefit both banks and regulators

Closing Remarks

Closing Remarks

- Banks in Hong Kong adopts Basel II since 2007 under the coordination of the HKMA.
- Basel II is an opportunity to allow banks to improve performance and create value systematically which is supported by regulators.
- Banks should prepare for the challenges in order to enjoy those benefits.

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**Briefing from Mr. Peter P.T. Li
(Partner, PricewaterhouseCoopers HK)
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**Questions
&
Answers**

Basel II:

Implementation Issues and Concerns

**End of Presentation
and
Thank you**