

Yiu-kwan Choi: Basel II implementation in Asia

Introductory remarks by Mr Yiu-kwan Choi, Deputy Chief Executive (Banking) of the Hong Kong Monetary Authority, at the BCBS/FSI/EMEAP: Basel II Implementation in Asia, Hong Kong, 17 October 2007.

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Dear colleagues,

Good morning. On behalf of the HKMA, I would like to extend a very warm welcome to you all here today to take part in this outreach event organized jointly by the Basel Committee, the FSI and EMEAP, focusing on the IRB validation aspect of the Basel II framework. The event coincides with one of the regular meetings of the Validation Subgroup of the Basel Committee's Accord Implementation Group, which was held here over the last two days.

The Validation Subgroup, or the AIGV as it is commonly called, is one of three subgroups under the AIG that share information and discuss specific issues related to Basel II implementation. The AIGV specifically explores issues related to the validation of systems used to generate the ratings and parameters that serve as inputs into the internal ratings-based approach to credit risk.

The AIGV has done some excellent work, using the regular AIGV meetings as an information dissemination platform for members of this Subgroup to explore various IRB validation-related issues. The AIGV has also published several high quality supervisory guidance papers covering topics on validation of low-default portfolios, use of vendor products, use test and control expectations for validation under the Basel II IRB framework. These topics, as I understand, will be discussed this afternoon under the two scheduled working group sessions. To broaden the geographical reach of the large pool of useful reference documents on IRB-related issues produced for its meetings or contributed by the member jurisdictions, the AIGV has developed an electronic library on eBIS to store these documents for access by the supervisory community.

The hosting of this event is well timed, as some jurisdictions have already entered into the implementation phase of the Basel II IRB framework and other jurisdictions, including many from Asia, are in the pipeline for the introduction of the framework for adoption by their banks. The event is therefore a good opportunity for representatives of jurisdictions which have yet to adopt Basel II to hear from jurisdictions already implementing the framework about the emerging issues, and to facilitate future communications on this topic among participants. As Chairman of the EMEAP Working Group on Banking Supervision, the HKMA certainly welcomes the opportunity to host this outreach event, and would like to thank the AIGV members who have stayed behind after the regular meeting to provide support.

A major innovation of Basel II is that it allows banks to calculate their regulatory capital requirements using the output of their internal rating systems, subject to supervisory approval. Under the IRB Approach, banks employ internal rating systems to produce estimates of one or more risk components, which are then used as the key inputs to the calculation of regulatory capital requirements for credit risk.

While there is a case for Asian regulators to perhaps concentrate their Basel II implementation efforts initially on the Standardised Approach, they would eventually like to see their banks, those large ones in particular, adopt the IRB Approach over time as adopting the IRB Approach can substantially enhance the quality of risk management of banks. Moreover, Asian regulators including the HKMA find ourselves in the position of playing host to many large and internationally active banking groups that propose to adopt the IRB Approach globally, including their operations in our jurisdictions. In consequence, we need to develop plans for the adoption of the IRB Approach in our domestic banking

environment. In doing so, we need to balance the readiness of the industry and other supervisory priorities versus the desirability of implementation of the IRB Approach.

On readiness of the industry, we believe that there are three key challenges facing banks in Hong Kong and probably other jurisdictions in Asia. First, the adoption of the IRB Approach by banks does not merely involve the use of sophisticated quantitative tools, but also corresponding advances in banks' risk management practices, culture, internal control and corporate governance. This is essentially the underlying and overarching principle of the IRB and other advanced approaches provided under the Basel II framework.

The Basel II framework makes it clear that a bank should be allowed to provide its own estimates of the risk components for the calculation of its regulatory capital requirement only on the basis of a sound internal control and oversight framework. From our experience, this represents the primary challenge for some banks as they may focus only on the quantitative aspects of adopting the IRB Approach, without taking necessary account of the qualitative aspects. Without a sound internal control and oversight framework, these quantitative tools might be employed improperly and generate incorrect information for credit and management decisions. As such, the drawbacks brought by the use of sophisticated tools could outweigh the benefits. Thus, validation standards for the internal rating systems adopted by banks will need to place as much emphasis on the qualitative as on the quantitative aspects of validation.

Data issues are another critical challenge facing banks and involve both quality and quantity aspects. On the quality side, it appears that the awareness of data integrity generally remains low on the management agenda. Some banks may still have the misconception that data management only requires an IT system to keep the numbers, and does not require senior management attention. In fact senior management need to take the lead in improving data quality. Apart from making available the necessary IT infrastructure and resources, this includes establishing an appropriate data management program as well as policies, standards and control mechanisms, and from time to time, emphasising the importance of data quality to the relevant personnel.

On the quantity side, since the notions of internal rating systems and the quantification of credit risks remain relatively new to the industry, some banks may have kept the relevant default and loss data only for recent years. Insufficient data consequently becomes an obstacle to the implementation of the IRB Approach by banks, in particular that the data collected so far may not be long enough to cover a complete business cycle. As such, the stability of an IRB system under different economic conditions cannot be meaningfully evaluated. The problem is especially consequential in Asia, as economic fluctuations in the region have tended to be faster and greater in magnitude than those in more mature banking markets.

The third challenge banks in Asia may face in adopting the IRB Approach is the paucity of internal resources necessary for rating system development and validation. Many banks have relied, or intend to rely, on external parties such as consulting firms and model vendors. Employing third-party services can be beneficial in respect of areas like professional expertise, knowledge transfer, the utilisation of a more comprehensive data set and assuring independence in the validation process. However, over-reliance on external parties does carry certain risks. One example is that banks may not have the internal expertise to assess the quality of the rating systems delivered by model vendors.

And it is not just the banks that face resource issues, it is the supervisors as well. In common with supervisors in the more developed markets, we face the challenge of limited internal resources and expertise with which to implement the IRB Approach. Moreover, banks and supervisors are often competing between themselves for the relevant expertise. In addition, the support to supervisors in Asia from external parties, such as academia, vendors, consulting firms and rating agencies, is more limited than in the developed markets. Finally, both banks and supervisors face a very steep learning curve in familiarising themselves with

the basic concepts and techniques on which the IRB Approach relies, and need to become more conversant with these types of risk management technique.

A particularly important issue to consider that is highly relevant to today's event is the standards that bank supervisors will apply in deciding whether or not to approve a bank to use the IRB Approach. To ensure that the capital charges computed by the IRB systems are sufficient for banks to withstand the credit risks they have incurred and to absorb the potential losses resulting from borrower defaults, the estimates of the risk components must be accurate in capturing the relevant aspects of risk. As a consequence, validation of banks' estimates of the risk components, and the underlying internal rating systems, is crucial to the implementation of the IRB Approach. This is one of the greatest implementation challenges confronting bank supervisors in Asia, where the development and understanding of the IRB Approach by banks is generally still at an early stage.

No matter what supervisory approach you take in respect of IRB validation, it is only one of the major questions to which we need to find an answer. Banks and their supervisors in Asia are going to face a variety of challenges ahead in the implementation of the Basel II IRB framework. Through today's outreach event, I hope that there will be stimulating discussions on these issues and that participants will be able to take away ideas that can help them make the implementation of the IRB framework in their jurisdictions a success. I also hope that the AIGV, the AIG and the Basel Committee can take account of the views of the Asian region, and of the particular issues we face.

Thank you.