Consultation Paper

Implementation of Basel III capital standards in Hong Kong (C1)
(Definition of Capital, Risk weighting framework for counterparty credit risk and Integration of Pillar 2)

Purpose

1. This paper outlines the HKMA's proposals for giving effect to certain aspects of the Basel III capital standards in Hong Kong and invites the banking industry's feedback on the proposals.

Overview

2. In December 2010, the Basel Committee on Banking Supervision issued a package of reforms to strengthen global capital and liquidity rules for banks with the goal of promoting a more resilient banking sector.

3. The reforms to the regulatory capital framework were set out in the document entitled *Basel III: A global regulatory framework for more resilient banks and banking systems* and include measures:-

   - to raise the quality, consistency and transparency of the regulatory capital base;

   - to strengthen the capital framework for counterparty credit risk (CCR) exposures arising from banks' derivatives and securities financing transactions by extending the risk coverage of the framework to capture mark-to-market losses due to deterioration in counterparties' creditworthiness and requiring the use of stressed inputs to determine capital requirements;

   - to encourage capital conservation and reduce procyclicality by promoting the build-up of a capital conservation buffer and, in times of excessive credit growth a countercyclical capital buffer, which can both be drawn-down in periods of stress; and

   - to introduce a leverage ratio, as a supplement to the risk-based capital measures, with a view to it constraining leverage in the banking sector and

serving as an additional safeguard against model risk and measurement error.

4. In a letter of 26 January 2011, the HKMA informed authorized institutions (AIs) of its support for the Basel III reform package and of its intention to consult the industry on its proposals for implementing the package in Hong Kong in due course.

5. This document is the first in a series of consultation papers which the HKMA intends to issue for the purpose of seeking the banking industry's feedback on proposals to implement the Basel III capital standards in Hong Kong. It focuses primarily on:-

- the requirements relating to the revised definition of capital (Section 1);
- the risk-weighting framework for CCR exposures (Section 2);
- the integration of Pillar 2 under Basel III (Section 3); and
- the implementation timeline (Section 4).

6. Other aspects of the Basel III capital package including the capital buffers, leverage ratio and disclosure requirements will be the subject of future consultations.

7. The HKMA will also be consulting the industry separately on its proposals for the implementation of the Basel III liquidity standards.

General Approach

8. There are considerable benefits in working towards international consistency in the calculation of banks' regulatory capital, both in terms of facilitating comparison between banks across jurisdictions and minimising burdens on internationally active banks. <u>As a general principle therefore, the HKMA proposes to adopt the Basel III requirements into the Banking (Capital) Rules (BCR) unless there are strong justifications in the local context for not doing so.</u>

9. In implementing the Basel III capital standards in Hong Kong, the HKMA intends to follow the transitional timeline set by the Basel Committee. Further

information on the HKMA's current thinking regarding the timeframe for the introduction of Basel III is set out in Section 4 of this paper.

Section 1

Definition of Capital

10. This section sets out the HKMA's proposals regarding the constituent elements of the capital base under Basel III.

Tiers of regulatory capital

11. Currently an AI's capital base consists of "Core Capital" and "Supplementary Capital".[1] Basel III also adopts a two-tier approach in recognizing:-

- ***Tier 1 Capital*** which is intended to absorb losses on a going concern basis whilst a bank continues in business and which comprises:

  – ***Common Equity Tier 1 (CET1) Capital; and***
  – ***Additional Tier 1 (AT1) Capital***

- ***Tier 2 Capital*** which is intended to absorb losses on a gone concern basis when a bank reaches the point of insolvency.

12. To ensure the quality of regulatory capital in terms of genuine availability to absorb losses either on a going concern or gone concern basis, Basel III strengthens the "entry criteria" for instruments to be included in the capital base and identifies a number of balance sheet items that should be deducted from the capital base (referred to as "regulatory adjustments").

13. The HKMA proposes to replace the existing categories of regulatory capital with the new Basel III classification and to follow closely the Basel III definitions for individual components within each of the two tiers of capital. There are, however, areas where the HKMA's existing regulatory capital framework in the BCR is more stringent than Basel III or not directly comparable to it. A policy decision is therefore required (in the light of the general principle in paragraph 8) on the extent to which the current approach should be retained or adapted to align with the relevant treatment under Basel III.

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[1] Reflecting the categorisation of regulatory capital under Basel II.

CET1 Capital

14. Under Basel III, CET1 capital consists of:

- ***Common (or ordinary) shares issued by the bank;***
- ***Share premium resulting from the issue of common shares;***
- ***Retained earnings and other disclosed reserves (including adjustments to reserves);***
- ***Common shares issued by consolidated subsidiaries of the bank and held by third parties (i.e. minority interests); and***
- ***Regulatory adjustments applied in the calculation of CET1 Capital*.**

Ordinary shares

15. This category covers a bank's issued and paid-up ordinary shares that meet the prescribed entry criteria for classification as common shares under Basel III. These criteria are reproduced in **Annex 1**. The HKMA proposes to adopt these criteria for AIs but with the proviso that shares issued through the capitalization of property revaluation reserves should be excluded from CET1 Capital. This exclusion reflects the HKMA's current policy as set out in section 38(a) of the BCR. Further discussion of the HKMA's proposed treatment of property revaluation gains for regulatory capital purposes is set out in paragraph 19(c).

Share premium

16. This category covers the amount standing to the credit of a bank's share premium account resulting from the issue of common shares that have been included in CET1 Capital. The existing framework, in section 38(c) of the BCR, provides that an AI's Core Capital includes "the amount standing to the credit of the institution's share premium account". This is wider than the Basel III criterion in that it may include share premium arising from the issue of non-common equity capital instruments, such as irredeemable non-cumulative preference shares. To align with the Basel III requirement, the HKMA proposes to confine share premium, for the purpose of inclusion in CETI Capital, to the amount standing to the credit of an AI's share premium account resulting from the issue of instruments included in CET1 Capital. (A similar principle will apply in respect of share premium to be included in AT1 Capital and Tier 2 Capital.)

Retained earnings and other disclosed reserves

17. Under the existing framework, in section 38(d) of the BCR, an AI's Core Capital includes its retained earnings (i.e. profit and loss account), which form part of its published reserves; its unaudited profit or loss of the current financial year and its profit or loss of the immediately preceding financial year pending audit completion. While this is in line with "retained earnings and other disclosed reserves" under Basel III, there are a number of areas relating to the calculation of retained earnings and reserves where the existing framework in the BCR differs from Basel III. These are described below together with an outline of the treatment which the HKMA proposes to apply.

Dividends proposed or declared

18. Basel III provides for dividends to be removed from a bank's CET1 Capital in accordance with applicable accounting standards. In Hong Kong, *HKAS 10*[2] only allows dividends to be recorded on the balance sheet after they have been declared (thus booking usually occurs in the following financial year). The existing regulatory capital framework is more stringent than *HKAS 10* in that the amount of retained earnings included in Core Capital for a financial year must be net of dividends that are proposed or declared by an AI, not only before, but also after, the end of the financial year. The HKMA proposes to retain the current more conservative requirement on the basis that earnings clearly earmarked for distribution as dividends should not generally be considered as available to absorb losses, and this approach should also encourage dividend retention when capital levels are low.

Unrealised fair value gains / losses

19. Broadly speaking, Basel III follows the accounting treatment for unrealised gains or losses recognized on the balance sheet, such that they can be included in the determination of CET1 Capital.[3] This applies to items booked in the banking book as well as the trading book.[4] Under the existing framework in

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[2] HKAS 10 *Events after the Reporting Period*

[3] There are exceptions for fair value gains or losses relating to changes in a bank's own credit risk on its fair valued liabilities, and the cash-flow hedge reserve, which are required to be derecognised as mentioned in paragraph 20.

[4] The Basel Committee has however indicated that it will continue to review the appropriate treatment of unrealised gains, taking into account the evolution of the accounting framework. (See footnote 10 of *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010.)

the BCR, the HKMA generally requires unrealised losses in respect of items not booked in the trading book to be deducted from Core Capital and unrealised gains in respect of these items to be derecognized (i.e. excluded) from Core Capital and included, to a limited extent, in Supplementary Capital. These include:

(a) **Equities and debt securities classified as "available for sale" (AFS) or "designated at fair value" (FVO)**. Unrealised gains on AFS or FVO securities are required to be derecognized (i.e. excluded) from Core Capital, but may be included in Supplementary Capital subject to a haircut of 55% (in other words only 45% of such unrealised gains can be included in Supplementary Capital).

This current "prudential filter" for derecognition of unrealized gains was in large part designed to address prudential concerns about the "quality" of the valuations of AFS or FVO securities. In future, however, AIs will be required to adopt more stringent standards on valuation under the revised Supervisory Policy Manual module issued by the HKMA in December 2011 on "Financial Instrument Fair Value Practices" (CA-S-10). This module incorporates the latest prudential valuation guidance from the Basel Committee, with a view to ensuring that the use of the fair value measurement is managed, monitored and reported in a sound and appropriate manner and that valuation adjustments are made, impacting CET1 Capital, to take account of any valuation uncertainty. The adoption of such guidance should increase the reliability and robustness of fair valuation and improve transparency around the proportion of regulatory capital that is comprised of unrealised gains.

The current prudential filter also has the advantage of reducing potential volatility and fluctuations in the capital base, leading in turn to more stable and conservative capital ratios. However, this "smoothing effect" has to be balanced against the effects of the filter in terms of putting AIs at a competitive disadvantage vis-à-vis their counterparts in other jurisdictions, which adopt the Basel III approach.

Having considered the various arguments for and against the filter, the HKMA proposes to adopt the Basel III approach of allowing unrealised gains and losses on AFS or FVO securities to be included in determining CET1 Capital.

(b) **AFS or FVO loans and receivables.** Both revaluation gains and losses in respect of loans and receivables classified as available for sale or designated at fair value are currently derecognized (i.e. excluded) in the calculation of the capital base. This reflects the prevailing treatment for these items under Basel II. In contrast, Basel III, in redefining the components of the capital base, does not specifically exclude these items meaning that they could be recognized.

The HKMA takes the view that AFS or FVO loans and receivables are in essence similar to debt securities that are held to maturity, in that they are intended to be held for interest income rather than for capital gains on disposal. Also, the valuation of these items is not, and will not be, subject to the same degree of conservatism as the valuation of AFS and FVO securities, the latter being subject to the new prudential valuation guidance referred to above. The HKMA therefore proposes that, for regulatory capital purposes, an AI's AFS or FVO loans and receivables should be measured at amortised cost, and that in the calculation of regulatory capital the current treatment of derecognising any revaluation gains and losses from these items should be retained.

(c) **Investment and own-use properties.** Under the existing framework, in sections 42(1)(a) and 43 of the BCR, any unrealised gains on the revaluation of properties held for investment or own-use are required to be derecognized (i.e. excluded) from Core Capital, but may be included in Supplementary Capital subject to a haircut of 55%. The amount of unrealised gains to be included in Supplementary Capital cannot, however, exceed the amount included for this item in a given AI's Supplementary Capital as at 31/12/1998 (the "1998 Cap"). On the assets side, the AI can deduct, from its total risk-weighted exposure, the amount of revaluation reserves in excess of the 1998 Cap. The rationale for this treatment is largely historical in that the property valuation reserves of most AIs dropped significantly during 1998 in line with local property prices at that time and the imposition of the 1998 Cap was intended to limit the impact of future volatility in property prices on AIs' capital adequacy ratios. The HKMA also indicated an intention in the longer term to move towards derecognition of property valuation reserves entirely as an item in AIs' capital base.

Having reconsidered the characteristics of unrealised gains on property in the context of Basel III, the HKMA considers that unrealised gains from property, whether held for investment or own-use, may not (particularly given the potential for volatility in the property market in Hong Kong) be completely and immediately available to absorb losses when needed on a going concern basis, and therefore should not merit recognition as CET1 Capital. However, it appears that it may be appropriate to afford such gains some measure of recognition in Tier 2 if the view is taken that the relevant properties would likely be disposed of in the event of insolvency. The consideration then becomes whether, and if so what, prudential filter should be applied in relation to the amount of such gains to be recognized. In particular, should the existing haircut continue to be applied and what should be done in respect of the 1998 Cap? The Cap is an absolute limit with no link to the amount of an AI's existing capital base, so it does not serve the purpose of limiting the proportion of property revaluation reserves in an AI's capital. Furthermore, there are AIs which cannot recognize any property revaluation reserves simply because there were no such reserves on their balance sheets as at 31 December 1998 (so the 1998 Cap applicable to them would be "zero"). The existence of the 1998 Cap therefore gives rise to level-playing issues not only among AIs in Hong Kong with different levels of Cap, but also between local AIs and their counterparts in other jurisdictions which impose no such restriction and allow banks to fully recognize revaluation gains from own use or investment properties.

On balance, the HKMA proposes to retain recognition of unrealized gains on property revaluation in Tier 2 Capital,[5] subject to the 55% haircut, but to remove the 1998 Cap. The retention of the 55% per cent haircut should assist in limiting any additional volatility in the capital base resulting from the removal of the 1998 Cap. Furthermore, inclusion of unrealized property revaluation gains within Tier 2 should ensure that they do not affect the volatility of the key CET1 and Tier 1 ratios , which going forward are expected to assume greater prominence and focus as measures of banks' resilience in comparison to the Tier 2 gone concern measure.

20. The existing treatment of the following items under the BCR already reflects that required under Basel III:

[5] As with the existing framework, however, an AI in calculating its Tier 2 Capital, will not be able to set-off losses in respect of properties held for own-use (which are recognised in the institution's profit and loss account) against unrealised gains (which are recorded as part of an AI's reserves in equity), and vice versa.

(d) **Cumulative gains and losses due to changes in a bank's own credit risk on fair valued liabilities**[6] - Basel III requires all unrealised gains and losses that result from changes in a bank's own credit risk on fair valued liabilities to be excluded from the capital base. Section 38(e)(ii) of the BCR already makes provision for this and therefore no change is required.

(e) **Cash flow hedge reserve** - Basel III requires that the amount of the cash flow hedge reserve that relates to the hedging of items measured at amortised cost (including projected cash flows), should be excluded from CET1 Capital. Sections 38(d)(ii) and (iii) of the BCR already provide for this and will be retained.

Regulatory reserve and collective impairment allowance

21. Under *HKAS 39*, only losses that are either (i) already incurred or (ii) to be incurred as a result of events that have already occurred, are recognized as impairment losses. A collective impairment allowance (CIA) can be made in respect of any such losses on collectively assessed exposures. Losses expected to arise out of future events, no matter how likely, are not recognized as impairment losses.

22. To ensure that AIs' loan loss provisions remain adequate following the adoption of *HKAS 39*, the HKMA requires AIs to maintain, in addition to their CIA, a non-distributable "regulatory reserve" (RR) to cover expected, but not yet incurred, credit losses. The RR in essence bridges the gap between the accounting and regulatory bases of loan provisioning, because from a regulatory perspective a purely incurred loss approach results in provisioning that is "too little too late".

23. The existing capital framework in the BCR allows limited recognition of AIs' RR and CIA in their Supplementary Capital. AIs using the Basic Approach or the Standardised Approach to the calculation of credit risk can include the amount of their RR and CIA in their Supplementary Capital up to a limit of *1.25% of total risk-weighted assets.* The excess portion, which is not included in Supplementary Capital, can be deducted from their total risk-weighted assets.

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[6] The Basel Committee published on 21 December 2011 a consultative document on *Application of own credit risk adjustments to derivatives*, which may have implications for the calculation of AIs' capital base under Basel III.

For AIs using the IRB approach, any excess of eligible provisions (i.e. the aggregate amount of RR, CIA and individual impairment allowance) over expected losses is included in Supplementary Capital up to a limit of *0.6% of credit risk-weighted assets*.

24. The HKMA's decision to permit partial recognition of CIA in Supplementary Capital was based on the view that CIA was broadly akin to the General Provision which existed pre-*HKAS 39* and that this treatment was generally in line with that adopted in other major financial centres.

25. This approach, however, needs to be revisited insofar as Basel II and Basel III only allow loan provisions to be included in Tier 2 Capital to the extent they are held against future presently unidentified losses and are freely available to meet losses. Provisions ascribed to the identified deterioration of particular assets or known liabilities, whether assessed individually or collectively, are excluded. The emphasis on "objective evidence" of impairment under *HKAS 39* is indicative that accounting provisions, which are by definition held against identified as opposed to unidentified losses, should not be included in regulatory capital given that they would not be available to meet other future "unexpected" losses. Moreover, the accounting profession have confirmed that their approach to the CIA is on an incurred-loss basis and advised that it would be misleading to describe the CIA as part of the capital cushion.

26. In addition, Basel III has now clarified that provisions eligible for inclusion in the Tier 2 Capital of AIs adopting the Standardised or Basic Approach to the calculation of credit risk should be limited to a maximum of 1.25% of <u>**credit**</u> risk-weighted assets instead of 1.25% of <u>**total**</u> risk-weighted assets.

27. <u>To align with Basel III, the HKMA therefore proposes that (i) CIA be excluded from AIs' capital base for the purposes of regulatory capital calculation; and (ii) for AIs adopting the Standardised or Basic Approach to the calculation of credit risk for regulatory capital purposes, the amount of RR to be included in Tier 2 Capital should be restricted to a maximum of 1.25% of **credit** risk-weighted assets.</u> The HKMA estimates that the combined impact of these two adjustments is unlikely to be significant. First, the credit risk-weighted assets of locally incorporated banks, which are users of the Standardised Approach or the Basic Approach and to which the 1.25% cap therefore relates, in general account for 90% of their total risk-weighted assets. Secondly, exclusion of CIA will create more "headroom" within the 1.25% cap for the recognition of RR.

28. Recently, strong credit growth in Hong Kong with the consequent likelihood of increasing levels of non-performing loans, has prompted the HKMA to request many AIs to review and increase their RR levels. Looking forward, the continued operation of the RR will be affected by the International Accounting Standards Board's (IASB) expected loss approach for provisioning which is still under development. Obviously, if the accounting provision moves from an incurred loss approach to an expected loss approach, the need for an additional prudential reserve, such as the RR, will diminish. The HKMA intends to review its policy on the RR as and when the IASB's expected loss provisioning approach is finalised. It is also the case that when developing proposals for the implementation of the capital buffers under Basel III, the HKMA will need to consider if, and to what extent, there is any overlap between the buffers and the RR, in line with the philosophy that the buffers (being capital) should be held against unexpected loss and the RR should be held against expected loss.

Minority interests arising from common shares issued by subsidiaries on consolidation

29. The proposed approach for recognising minority interests in CET1 Capital is set out in paragraphs 78 to 84.

Regulatory adjustments to CET1 Capital

30. The proposed approach to deductions arising from regulatory adjustments in determining CET1 Capital is explained in paragraphs 51 to 77.

AT1 Capital

31. Under Basel III, the AT1 Capital of a bank can include:

- ***Capital instruments issued by the bank;***
- ***Share premium resulting from the issue of such instruments;***
- ***Capital instruments issued by the consolidated subsidiaries of the bank and held by third parties; and***
- ***Regulatory adjustments applied in the calculation of AT1 Capital.***

Capital instruments

32. Capital instruments issued by a bank can be included in the bank's AT1 Capital if they meet prescribed criteria and are not included in CET1 Capital. The prescribed entry criteria for classification as AT1 Capital under Basel III are reproduced in **Annex 2**. The HKMA supports the principle that instruments included in AT1 Capital must be able to absorb losses whilst the AI remains a going concern. The HKMA proposes to reclassify relevant constituent elements of Core Capital and Supplementary Capital into AT1 Capital and effect any necessary amendment of their qualifying criteria to bring them into line with the AT1 entry criteria.

33. One particular feature of this process which merits further discussion is the requirement in Basel III that instruments (other than common equity) must have principal loss absorption ability through a conversion or write-down mechanism in order to be eligible for inclusion in the capital base.

Objective pre-specified trigger point

34. For instruments classified as liabilities for accounting purposes to be included in AT1 Capital, Basel III requires that they be capable of being written down or converted at a "pre-specified trigger point". In principle, this trigger point should be set at a level to ensure conversion / write-down well before the emergence of distress at the bank in order to ensure prompt recapitalization and thereby enable it to continue as a going concern. The Basel Committee has provided further guidance in its *Basel III definition of capital – Frequently asked questions*,[7] which state that AT1 Capital instruments accounted for as liabilities should at least comply with the following minimum standards:

- the write-down / conversion must be triggered when a bank's CET1 Capital ratio is at or below 5.125%;

- the write-down / conversion must generate CET1 Capital under the relevant accounting standards and the instrument will only receive recognition in AT1 Capital up to the minimum level of CET1 Capital generated by a full write-down / conversion of the instrument; and

- the aggregate amount to be written-down / converted for all such

[7] Last updated on 16 December 2011.

instruments must be at least the amount needed to immediately return the bank's CET1 ratio to the trigger level or, if this is not possible, the full principal value of the instruments.

35. There are a range of views amongst regulators as to where the trigger level should most appropriately be fixed. Some regulators have indicated support for a lower trigger level when the CET1 Capital ratio falls to or below 5.125% (viz., 4.5% minimum CET1 ratio + 0.625% being the upper bound of the 1st quartile of the 2.5% capital conservation buffer (i.e. the level below which a bank is fully prohibited from making any distributions on Tier 1 Capital instruments)). The operation of the capital conservation buffer is explained in **Annex 3**.[8] Other regulators support a higher trigger level at a CET1 Capital ratio of 7%. This represents the upper end of the capital conservation buffer and is, therefore, the point at which constraints on distributions on Tier 1 Capital begin.

36. The HKMA is minded to adopt a trigger towards the lower end of the spectrum, but considers that there is a need to factor in Pillar 2 capital requirements, given that the HKMA's proposed approach for the integration of Pillar 2 under Basel III is to apportion any Pillar 2 capital requirement between CET1 Capital, AT1 Capital and Tier 2 Capital (see Section 3) and treat it as part of AIs' minimum capital requirements. On this basis, the HKMA would propose that the trigger level should be the aggregate of the minimum CET1 Capital ratio of 4.5%, the Pillar 2 apportionment added to the CET1 Capital ratio and 0.625% (i.e. the first quartile of the capital conservation buffer).

37. However, as Pillar 2 capital requirements are bank specific and vary among AIs, and there is a need to specify a common benchmark trigger ratio applicable across the board, the HKMA is proposing to use a simple arithmetic average of the Pillar 2 capital requirements for major locally incorporated banks. This would generate a 2% figure (as the range is from 1% to 3%) with an apportionment of 1.125%[9] to the CET1 Capital ratio and result in a trigger at 6.25% (i.e. 4.5% + 1.125% + 0.625%). If the mechanism for a higher trigger (i.e. set at the upper end of the conservation buffer) were adopted, the result would be a trigger level of 8.125% (i.e. 4.5% + 1.125% + 2.5%).

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[8] As noted in paragraph 6 the HKMA's proposals for implementation of the Basel III capital buffers will be the subject of a separate consultation.

[9] 2% x 4.5%/8% = 1.125%. See Section 3 for a discussion of the proposed apportionment approach for the Pillar 2 add-on.

38. As the lower trigger point will have the merit of lowering banks' cost of funding and hence preserving their ability to raise capital, the HKMA proposes that write-down or conversion be triggered when the issuing AI's CET1 Capital ratio is at or below 6.25%.

Regulator-determined trigger event

39. Under Basel III, **all instruments** (other than common equity) eligible for inclusion in the capital base as AT1 or Tier 2 Capital must have contractual terms allowing them to be written-off or converted into common equity in the event that the bank is unable to support itself without such write-off or conversion[10] [11]. The concept is that such instruments should fully absorb losses at the "point of non-viability". The trigger event is therefore the earlier of: (i) a decision that a write-off, without which the firm would become non-viable, is necessary as determined by the relevant authority; or (ii) the decision to make a public sector injection of capital or equivalent support without which the firm would have become non-viable as determined by the relevant authority.

40. AIs in Hong Kong will be required to include "point of non-viability" conversion / write-down clauses in the terms of their capital instruments, on and after 1 January 2013, in line with the Basel Committee's transitional timeline. In the interim period up to 1 January 2013, the HKMA encourages AIs to consider including such clauses into the terms of any capital instruments they intend to issue. AIs intending to issue capital instruments that do not include "point of non-viability" conversion or write-down provisions, and which as a result will be subject to "phase-out" from 1 January 2013[12], are expected to consult the HKMA prior to the issuance of such instruments.

41. As noted above a "point of non-viability" conversion / write-down provision is required to be included in the terms and conditions of all AT1 Capital and Tier 2 Capital instruments (other than common equity). The question therefore arises as to whether the holders of AT1 Capital instruments should take losses prior to

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[10] The requirement was announced in the Basel Committee's press release of 13 January 2011 on *Minimum requirements to ensure loss absorbency at the point of non-viability*.

[11] The only exception is where the laws of a given jurisdiction result in a similar effect absent a specific contractual term.

[12] Please refer to paragraph 125 for a description of the phase-out arrangements in the Basel III transitional timeline.

the holders of Tier 2 Capital instruments at the "point of non-viability". The usual subordination hierarchy would dictate that holders of Tier 1 Capital instruments should take losses before holders of Tier 2 Capital instruments and therefore some form of mechanism for the apportionment of losses to different types of instruments on a point of non-viability trigger is required. Discussions are on-going internationally in this area and the HKMA will consult on this aspect at a later stage, once consensus is reached internationally on how to effect a "progressive" loss apportionment.

Share premium

42. This category covers the amount standing to the credit of a bank's share premium account resulting from the issue of capital instruments included in AT1 Capital. As noted above in paragraph 16 the HKMA proposes to confine share premium, for the purpose of inclusion in AT1 Capital, to the amount standing to the credit of an AI's share premium account resulting from the issue of instruments included in AT1 Capital.

Minority interests arising from AT1 capital instruments issued by subsidiaries on consolidation

43. The proposed approach for recognising minority interests in AT1 Capital is set out in paragraphs 78 to 84.

Regulatory adjustments to AT1 Capital

44. The proposed approach to deductions arising from regulatory adjustments in determining AT1 Capital is explained in paragraphs 51 to 77.

Tier 2 Capital

45. Under Basel III, the Tier 2 Capital of a bank can include:

- ***Capital instruments issued by the bank;***
- ***Share premium resulting from the issue of such instruments;***
- ***Capital instruments issued by the consolidated subsidiaries of the bank and held by third parties***; and
- ***Regulatory adjustments applied in the calculation of Tier 2 Capital.***

Capital instruments

46. Capital instruments issued by a bank can be included in the bank's Tier 2 Capital if they meet prescribed criteria and are not included in AT1 Capital. The prescribed entry criteria for classification as Tier 2 Capital under Basel III are reproduced in **Annex 4**. Instruments included in Tier 2 Capital must also include point of non-viability conversion or write-down clauses as described in paragraphs 39 to 41. The HKMA supports the principle that instruments included in Tier 2 Capital must absorb losses upon insolvency. The HKMA proposes to reclassify relevant constituent elements of Supplementary Capital into Tier 2 Capital and effect any necessary amendment of their qualifying criteria to bring them into line with the Tier 2 entry criteria.

Share premium

47. This category covers the amount standing to the credit of a bank's share premium account resulting from the issue of capital instruments included in Tier 2 Capital. As noted above in paragraph 16 the HKMA proposes to confine share premium, for the purpose of inclusion in Tier 2 Capital, to the amount standing to the credit of an AI's share premium account resulting from the issue of instruments included in Tier 2 Capital.

Minority interests arising from Tier 2 capital instruments issued by subsidiaries on consolidation

48. The proposed approach for recognising minority interests in Tier 2 Capital is set out paragraphs 78 to 84.

RR and CIA

49. The proposed treatment of these two items is described in paragraphs 21 to 28.

Regulatory adjustments to Tier 2 Capital

50. The proposed approach to deductions arising from regulatory adjustments in determining Tier 2 Capital is explained in paragraphs 51 to 77.

Regulatory adjustments

51. Basel III identifies a number of balance sheet items that should be deducted from a bank's capital base (mostly from CET1 Capital) for the purpose of calculating regulatory capital requirements. These items can be broadly classified into:

    Items that ultimately may not provide the bank with loss absorbent capital to the extent of their accounting value ("contingent items"). These include:

    - Goodwill and other intangibles (with mortgage serving rights receiving limited recognition);
    - Deferred tax assets (with those relating to timing differences receiving limited recognition);
    - Shortfalls in the stock of provisions relative to expected losses under the IRB approach to the calculation of credit risk;
    - Gains on sale related to securitization transactions; and
    - Defined benefit pension fund assets and liabilities.

    Items that inflate regulatory capital within the financial system by virtue of their "double-gearing effect" ("double-gearing items"). These include:

    - Investments in own capital instruments;
    - Reciprocal cross holdings in the capital of banking, financial and insurance entities; and
    - Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory capital consolidation.

Contingent items

52. Under the existing framework, most of the "contingent items" identified above are already required to be deducted from an AI's capital base (either fully from Core Capital or equally from Core Capital and Supplementary Capital).

Goodwill and other intangible assets

53. Section 48(1) of the BCR currently requires that the amount of goodwill and other intangible assets reported in the latest audited financial statements of an AI should be deducted fully from its Core Capital. To align with Basel III, the HKMA proposes to include a clarification to the effect that the amount to be deducted should be net of any associated deferred tax liabilities. Deduction will be made from CET1 Capital.

54. Basel III allows limited recognition of mortgage servicing rights (MSRs) when calculating CET1 Capital. Given that AIs in Hong Kong generally do not have MSRs on their balance sheets, the HKMA proposes to retain the current treatment of deduction of all intangible assets and to require that the deduction should be made from CET1 Capital.

DTAs

55. *HKAS 12 Income Taxes* provides that a deferred tax asset (DTA) shall be recognized to the extent that it is probable that taxable profit will be available against which it can be utilized (with some identified exceptions). In consideration of the fact that a sudden unexpected failure of a bank would essentially render the DTAs worthless, the existing framework in the BCR requires an AI to deduct the amount of net DTAs from its Core Capital.

56. Basel III distinguishes DTAs into those that rely on the future profitability of the bank to be realised and those relating to timing differences.[13] Within the Basel III framework, DTAs that rely on the future profitability of the bank to be realised must be deducted from CET1 Capital, whilst DTAs relating to timing differences receive limited recognition.

57. Notwithstanding the approach taken in Basel III, the HKMA remains of the view that even realisation of DTAs arising from timing differences depends on an AI having sufficient taxable profit for the offset of the tax asset. The HKMA therefore proposes that **all** DTAs, net of deferred tax liabilities

[13] A timing difference would occur, for instance, between the time at which loan loss provisions are recognized for tax purposes (which is at the time of realization) and the time at which loan loss provisions are recognized for accounting purposes (which is at the time the provision is made).

(DTLs),[14] be fully deducted from CET1 Capital. In line with Basel III, DTAs may be netted with DTLs only if the DTAs and DTLs relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority.

Shortfall of the stock of provisions to expected losses

58. Section 48(2)(b) of the BCR currently requires a shortfall of the stock of provisions to expected losses, under the IRB approach, to be deducted from Core Capital and Supplementary Capital on an equal basis. Under Basel III, the shortfall should be deducted entirely from CET1 Capital. The HKMA proposes to amend the current requirement so any such shortfall is deducted fully from CET1 Capital to be consistent with Basel III.

Gains-on-sale related to securitization transactions

59. Section 48(1)(d) of the BCR currently requires any increase in equity capital resulting from a securitization transaction to be deducted from Core Capital. Under Basel III, such gains-on-sale should be entirely deducted from CET1 Capital. The HKMA proposes to amend the current requirement so any such gain-on-sale is deducted fully from CET1 Capital to be consistent with Basel III.

Defined benefit pension fund assets and liabilities

60. Basel III requires that defined benefit pension fund liabilities must be fully recognized (i.e. excluded) in the calculation of CET1 Capital. For each defined benefit pension fund that is an asset on the balance sheet, the asset should be deducted in the calculation of CET1 Capital net of any associated deferred tax liabilities. Assets in the fund to which the bank has unrestricted and unfettered access can, however, with supervisory approval, be risk-weighted rather than deducted. This treatment addresses the concern that assets arising from pension funds may not be capable of being withdrawn and used for the protection of depositors and other creditors of a bank.

61. Under the existing regulatory capital framework in Hong Kong, the defined benefit pension fund assets of an AI are risk-weighted. The HKMA proposes

[14] Amounts netted on deduction of goodwill, intangibles and defined benefit pension assets are also excluded.

to align the requirements in the BCR fully with the requirements under Basel III so that defined benefit pension fund assets and liabilities will be deducted from CET1 Capital absent any supervisory approval to risk-weight "accessible" assets..

Double-gearing items

62. The current treatment of double-gearing items in the BCR is not directly comparable to the required treatment under Basel III. The BCR focus on different classifications of counterparty (meaning in this context the entity in which the relevant investment is made) and coverage of exposures, whereas the Basel III requirements focus on whether or not a counterparty is a financial entity. Also, instead of deductions being made on an equal basis from Core Capital and Supplementary Capital, Basel III requires deduction of investments in a bank's own capital instruments and in the capital of other financial entities to be made on a "corresponding deduction approach". Deduction should therefore generally be applied to the corresponding tier of capital for which the capital investment, subject to deduction, would qualify if it were issued by the investing bank itself. If the corresponding tier is insufficient to satisfy the required deduction, the shortfall will be deducted from the next higher tier of capital.[15]

Investments in own shares and other capital instruments

63. To avoid double-counting of own capital, a bank is required under Basel III to fully deduct, from its capital base, capital investments in its own common shares and other capital instruments, whether held directly or indirectly (such as through holdings of index securities). In addition, any such instruments which the bank could be contractually obliged to purchase should also be deducted. Gross long positions may be deducted net of short positions in the same underlying exposure only if the short positions involve no counterparty risk.

64. The HKMA proposes to amend the BCR in line with Basel III and implement a "look through" arrangement for indirect exposure to an AI's own capital instruments.

[15] For example, if an AI does not have enough Tier 2 Capital to satisfy the deduction, the shortfall will be deducted from the institution's AT1 Capital and, should that also be insufficient, then from the institution's CET1 Capital.

Reciprocal cross holdings in the capital of banking, financial and insurance entities

65. The existing framework in the BCR requires AIs to deduct, on an equal basis from their Core Capital and Supplementary Capital, any holding of shares and other regulatory capital instruments issued by <u>any bank</u> that is: (i) the subject of an arrangement whereby two or more persons agree to hold each other's capital or (ii) a strategic investment. This reflects the existing Basel II treatment of reciprocal cross holdings designed to artificially inflate capital positions. Basel III extends the scope of the deduction to cover reciprocal cross-holdings in the capital of insurance and other financial entities, and requires any such deduction to be made on the corresponding deduction approach. <u>The HKMA proposes to follow the broader Basel III requirement in order to minimize the double-gearing of capital within the financial system as a whole.</u>

Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation

66. There are significant differences between the existing framework in the BCR and Basel III in relation to the deduction of an AI's capital investments in other companies:

- Section 48 of the BCR looks at the relationship between the AI and the entity in which the investment is made in order to determine deductibility, regardless of whether the entity is a financial or non-financial entity. An AI's capital investments in the following types of entity are required to be deducted: holding company, associated company (AI controlling 20% of the voting rights), subsidiary undertakings and connected companies (as defined under section 35 of the BCR).[16] Deduction is required to be made equally from Core Capital and Supplementary Capital.

- The Basel III deduction framework, in contrast, focuses primarily on whether the relevant entity is a financial entity (including a banking or an insurance entity) and whether the investment is a "significant investment" (i.e. a holding of 10% or more of the relevant entity's share capital or where the entity is an affiliate of the bank). Capital investments in

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[16] In addition to the deduction of shares and debentures issued by a connected company, section 48(2)(f) of the BCR also requires an AI to deduct any of its loans to a connected company (paragraph (i)) and any guarantees of the liabilities of a connected company (paragraph (iii)), except where the AI demonstrates to the satisfaction of the HKMA that the loan was made, the shares and debentures are being held, or the guarantee was given in the ordinary course of the AI's business.

non-financial entities are subject to risk-weighting rather than deduction. The deduction of capital investments under Basel III extends to indirect and synthetic holdings (such as through the holdings of index securities). Basel III also provides supervisors with discretion to apply "concessionary thresholds"[17] below which banks can risk-weight the investment rather than deducting it.[18] Furthermore, any investment issued by a regulated financial entity, but not included in the regulatory capital of the relevant financial sector to which that entity belongs, is not required to be deducted. In contrast to the current position under the BCR, Basel III provides no exemption for investments in banks that are not the subject of cross holding or strategic investment or for investments in connected companies incurred in the ordinary course of business.

67. Comparing the existing framework in the BCR and the new Basel III provisions, it appears that in certain respects the current framework is more conservative than Basel III and in others less so. Further, it seems clear that attempts to merge the current framework and Basel III would, at best, result in an overly complicated framework and, at worst, create a confused and non-cohesive set of requirements.

68. <u>The HKMA therefore proposes to move from the current approach of looking primarily at the relationship between the AI and the entity in which the investment is made and to focus on double-gearing within the broader financial system as a whole in the manner of Basel III.</u>

69. If the predominant objective is to minimize the double-counting of regulatory capital, this inevitably raises questions about the desirability of exercising the supervisory discretion to apply the "concessionary thresholds" (referred to in paragraph 66) and allow even limited recognition of "significant" shareholdings

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[17] For insignificant investments in the capital instruments of unconsolidated financial entities, paragraph 81 of *Basel III: A global regulatory framework for more resilient banks and banking systems* specifies that any amount up to 10% of the investing bank's common equity is allowed to be risk-weighted according to the relevant approaches. For significant investments in the common shares of unconsolidated financial entities, paragraphs 87 to 89 allow any amount up to 10% of the investing bank's common equity to be risk-weighted at 250%, subject to the additional restriction that the amount of such investments (together with the investing bank's MSRs and DTAs that arise from temporary timing differences) does not exceed 15% of the investing bank's common equity.

[18] Under Basel II, where a bank demonstrates that it is an active market maker then a national supervisor may establish a dealer exception for holdings of other banks', securities firms', and other financial entities' capital instruments in the trading book. In order to qualify for the dealer exception, the bank must have adequate systems and controls surrounding the trading of financial institutions' eligible regulatory capital instruments. (paragraph 689(ii) of *International Convergence of Capital Measurement and Capital Standards A Revised Framework Comprehensive version June 2006*.)

in non-consolidated financial institutions.

70. Only a "full deduction approach" achieves the objective of negating double-gearing and it has the added benefit of simplicity. The HKMA therefore proposes not to adopt the concessionary thresholds but to require full deduction of investments in the capital instruments of non-consolidated financial institutions. The HKMA is however interested to hear views from the industry as to the anticipated effect this approach would have on their business activities in relation to market making, proprietary trading, or investments in the capital instruments of other banks that are not subject to deduction under the current framework (because they are not the subject of cross-holding or strategic investment).

71. Although not strictly a double-gearing issue, the HKMA is also considering whether there is a need for some form of "anti-avoidance" provisions to enable the HKMA to require deduction of credit exposures to financial entities in very exceptional circumstances where such exposures are in nature substantially similar to capital investments (because, for instance, a loan is constantly rolled over on each maturity date). The HKMA would be interested to hear the views of the industry in this regard.

Phase-in of regulatory adjustments

72. The Basel III transitional timetable provides for a five year "straight-line" phase-in (at increments of 20% a year) of the deduction of those items not currently required to be deducted from banks' capital base. The HKMA proposes to adopt this phase-in approach in respect of items not currently required to be deducted under the existing framework in the BCR, in order to provide time for AIs to adjust their capital positions gradually. There will be no phase-in period for items that are currently subject to deduction under the existing framework.

Application of regulatory adjustments

73. The HKMA proposes to adopt the approach of Basel III in requiring deductions generally to be made to CET1 Capital and to adopt the "corresponding deduction approach" of Basel III (see paragraph 62) in relation to capital investments in other financial institutions. Thus,

- contingent items listed in paragraph 51 will be required to be fully deducted from CET1 Capital with effect from 1 January 2013, save for defined benefit pension fund assets and liabilities which can be deducted over a 5 year period; and

- double-gearing items listed in paragraph 51 will be deducted on the "corresponding deduction approach" with effect from 1 January 2013, save for items that are not currently required to be deducted under the existing framework (e.g. holdings of capital investments in any banks which are neither the holding company, associated company, nor subsidiary undertaking of the investing AI, and the capital investments are neither the subject of cross-holding nor strategic investment), which can be deducted over a 5 year period.

74. The deductable amount of items eligible for the 5 year phase-in arrangement will be limited to the amount outstanding as at 31 December 2012. Any amount incurred after that date should be fully deducted immediately.

Other deductions from CET1 Capital

Capital shortfall of regulated non-bank subsidiaries

75. In line with Basel II, the existing framework in the BCR requires that any capital shortfall in a subsidiary of an AI which is an insurance or securities subsidiary, and hence subject to regulatory supervision, shall be deducted from the AI's capital base (equally from its Core Capital and Supplementary Capital).

76. The HKMA proposes to retain this existing treatment, but to require that the capital shortfall be deducted from CET1 Capital.

Valuation adjustments

77. Valuation adjustments made by an AI to its exposures measured at fair value are required under the existing framework in the BCR (as amended in 2011) to be deducted from capital base, net of the adjustments made by the institution in accordance with the financial reporting standards. The HKMA proposes that this deduction be made to CET1 Capital with effect from 1 January 2013 in line with the principle the Basel III standards adopt for the treatment of unrealised losses.

Minority interest held by third parties in consolidated subsidiaries

78. The recognition of minority interests under Basel III also differs significantly from the existing framework in the BCR which largely reflects the Basel II approach.

79. For the purpose of calculating a banking group's consolidated capital adequacy ratio, the current regime permits full recognition of minority interests arising from the consolidation of partially-owned subsidiaries engaged in any "relevant financial activity"[19] (as defined in the BCR). The minority interest that may currently be recognized includes that arising from irredeemable non-cumulative preference shares issued by a subsidiary in the form of a special purpose vehicle. However, in this case the amount allowed to be included in the parent AI's Core Capital is limited to 15% of that Core Capital, with any excess amount included in the AI's Supplementary Capital.

80. Under Basel III, an amount in respect of minority interest arising from capital instruments issued by any subsidiary of a parent bank will be recognized in the corresponding capital tier (CET1 Capital , Tier 1 Capital and Total Capital) of the parent bank, provided that the subsidiary is itself a bank[20] and that the capital instruments if issued by the parent bank itself would meet the entry criteria for the relevant tier of capital.

81. In such cases the amount of minority interest that will be recognized must not include any surplus capital (i.e. capital exceeding the minimum that the subsidiary has to maintain to meet both the minimum ratios and the capital conservation buffer that are applicable to it) that is attributed to minority shareholders.

82. Where minority interests are currently recognized but will not be so in future under Basel III, the Basel Committee's transitional timetable allows a 5 year "straight-line" phase-out period (i.e. 20% exclusion on 1 January 2014, 40% on 1 January 2015 and so forth). Minority interests in this category include minority interests arising from:

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[19] These however exclude subsidiaries which are insurance companies or securities firms. In the case of these companies or firms, an AI's capital investment is required to be deducted from its capital base.

[20] This includes an institution that is subject to the same minimum prudential standards and level of supervision as a bank.

- capital instruments issued by subsidiaries engaging in any relevant financial activity which are neither banks nor institutions that are subject to the same minimum prudential standards and level of supervision as banks; and

- capital instruments issued by subsidiaries which are banks and which either (i) meet the Basel III entry criteria for the relevant tier of capital but represent the surplus capital attributed to minority shareholders, or (ii) do not meet the Basel III entry criteria.

83. The Basel III requirement is more restrictive than the existing framework in the BCR. It is more prudent in recognizing that the minority interest at subsidiary level may not ultimately be available to support risk in the group as a whole. The HKMA therefore proposes to adopt the Basel III approach in limiting recognition of minority interests and to adopt the phase-out arrangements in the Basel Committee's transitional timetable.

84. Some illustrative examples of the computation of eligible minority interests to be included in an AI's capital base under Basel III are enclosed at **Annex 5**.

Former deductions from capital to be risk weighted at 1250%

85. Basel III provides for the following items (which under Basel II, and hence under the existing framework in the BCR, are deducted on an equal basis from Core Capital and Supplementary Capital) to be risk weighted at 1250%.

- ***Securitization exposures subject to deduction* -** This refers to securitization exposures (in both the banking book and the trading book) that are subject to deduction under the current securitisation framework.[21]

- ***Certain equity exposures under the PD / LGD approach*[22] -** For an AI adopting the PD / LGD approach to calculate credit risk in respect of its equity exposures, this refers to the expected loss amount of such exposures as calculated in accordance with the BCR (section 48(2)(i) of BCR).

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[21] See paragraphs (d) and (e) of Schedule 5 of the BCR together with sections 68, 236, 237, 240, 251, 262, 277, 287A, 307 of the BCR (as amended by the Banking (Capital) (Amendment) Rules 2011.

[22] See section 139(1) of the BCR for definition of "PD / LGD approach"

- ***The first loss portion of the credit protection in respect of an AI's exposures -*** This refers to the amount of the first loss portion of the credit protection in respect of an AI's exposures referred to in paragraphs (a) and (b) of Schedule 5 of the BCR where the AI uses Standardised or Basic Approach to calculate credit risk in respect of its exposures.

  Non-payment / delivery on non-DVP[23] transactions - This refers to an AI's exposures (in terms of amounts paid or value of assets delivered or differences between agreed settlement price and current market price) in respect of securities (other than repo-style), foreign exchange or commodities transactions entered into on a non-DVP basis and which remain unsettled after the contractual settlement date for 5 business days or more (see paragraph (c) of Schedule 5 of the BCR).

Significant investments in commercial entities

86. Section 48(2)(g) of the BCR provides for deduction from capital base of the net book value of any shareholding in a company (i.e. other than one that is a holding company, associated company, subsidiary undertaking or connected company of an AI) in excess of 15% of an AI's capital base.

87. Under Basel III, any capital holdings in companies outside the financial sector, are to be risk weighted at 1250% where a bank controls more than 20% of the voting power of any such company. Where the amount of the bank's capital holding in any company, or companies in aggregate, exceeds 15% of the bank's capital base, the bank shall apply a risk weight of 1250% to the portion of those holdings in excess of 15% of the bank's capital base.

88. <u>The HKMA proposes to adopt the Basel III approach of applying a 1250% risk weight to all of the items listed in paragraphs 85 to 87 above.</u>

89. The HKMA is also considering whether there is a need for some form of "anti-avoidance" provision to enable the HKMA to require credit exposures to commercial entities to be risk-weighted at 1250% under very exceptional circumstances where such exposures are in nature substantially similar to capital investments (because, for instance, a loan is constantly rolled over on each maturity date). The HKMA would be interested to hear the views of the

[23] Delivery versus payment which, as defined in section 2(1) of the BCR, includes payment versus payment.

industry in this regard.

Proforma

90. For illustrative purposes, a proforma is enclosed in **Annex 6** showing the structure and individual components of the regulatory capital base in accordance with the Basel III framework.

Section 2

Risk-weighting Framework for Counterparty Credit Risk Exposures

91. This section sets out the HKMA's proposed approach to revising the risk weighting framework for CCR exposures in the BCR.

CCR framework for bilateral transactions

92. The existing Basel II regulatory capital framework provides three methods by which banks can calculate capital requirements for CCR exposures. These are: the current exposure method (CEM), the standardised method (SM) or, with prior supervisory approval, the internal model method (IMM). For historical reasons, the current regime in the BCR only makes the CEM available to AIs in Hong Kong. The HKMA has however been monitoring the need to introduce the SM or IMM approaches at such time as AIs demonstrate a substantial appetite to adopt them.

93. Basel III will introduce a number of measures to strengthen the treatment of CCR under Basel II. These include some measures which are particularly relevant to the IMM including enhancements to the **existing default risk capital charge**, (by requiring the use of stressed inputs in the capital calculation and strengthening risk management standards), as well as the introduction of a **new capital charge for credit valuation adjustments ("CVA")** to capture potential mark-to-market losses (for example where a counterparty has its rating downgraded as opposed to a counterparty default). Banks with supervisory approval to use the IMM for their CCR and specific interest rate risk capital calculations will be able to use an advanced methodology for calculating the CVA. Other banks will be required to use a standardised methodology for the calculation.

CCR framework for transactions with CCPs

94. In addition to the bilateral CCR measures discussed above, the Basel Committee has been working on the determination of capital requirements for bank exposures to central counterparties (CCPs) in the light of the work of the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) in this area. The Basel Committee is expected to issue its final standards on the capitalisation of bank

exposures to CCPs in early 2012. It is anticipated that these standards will prescribe (i) the capital treatment for banks' "trade exposures" (covering collateral posted, mark-to-market exposures and potential future exposures) to "qualified" CCPs[24] (where a concessionary low risk weighting will be allowed - in the prior consultation, a 2% level was proposed); (ii) the capital treatment for banks' "trade exposures" to their clients and CCP clearing members in respect of transactions cleared by CCPs (covering collateral posted, mark-to-market exposures and potential future exposures) as well as (iii) methodologies for calculating the capital charge for banks' default fund exposures to CCPs. Transactions with "non-qualified" CCPs are expected to be treated as normal bilateral transactions (and will be subject to the default risk capital charge and the CVA capital charge mentioned in paragraph 93). It is anticipated that the default fund contributions to "non-qualified" CCPs will be subject to a risk-weight of 1250%.

Default risk capital charge

95. The HKMA proposes to introduce the IMM as an alternative approach to the CEM in Hong Kong. The HKMA's observes little demand or appetite amongst AIs for the introduction of the SM in Hong Kong. It appears that the SM's requirements for decomposition of each transaction into various risk positions (i.e. equity, interest rate and foreign exchange positions, where applicable) may not accord with the way in which AIs presently manage their CCR exposures and hence could have significant system implications if adopted. It appears that implementation of the SM may therefore further complicate the CCR framework with no significant demonstrable utility.

96. The HKMA proposes that any AI, regardless of the approach it uses to calculate credit risk and market risk, may apply to the HKMA for approval to use the IMM to calculate its default risk exposure. In order to obtain the requisite approval, the AI must demonstrate to the satisfaction of the HKMA that it meets all the minimum requirements for using the IMM set out in the Basel CCR framework.[25]

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[24] A qualified CCP is a CCP (i) that has been licensed by a CCP regulator who exercises prudential supervision of licensed CCPs in accordance with the relevant principles issued by the CPSS and IOSCO; and (ii) that has made available data necessary for banks to calculate the capital charge for their default fund exposures to the CCP under the CCP framework.

[25] This refers to Annex 4 to the document "International Convergence of Capital Measurement and Capital Standards – A Revised Framework (Comprehensive Version)" issued in June 2006, as modified by Basel III.

97. Under the IMM, an AI will be required to calculate the amount of its default risk exposure by multiplying the effective expected positive exposure estimated by the AI by a factor of 1.4. An AI may take into account cross-product netting and margin agreements in the default risk exposure calculation if the respective eligibility requirements (which will be in line with those under the Basel CCR framework) are met.

98. The IMM approach to be introduced in Hong Kong will include the enhancements introduced by Basel III to the CCR framework, including those that also affect non-CCR related credit risk calculations, such as -

    (a) an asset value correlation multiplier of 1.25 for exposures to regulated financial institutions (with asset size of US$100 billion or more) and unregulated financial institutions (regardless of asset size);

    (b) longer minimum holding periods for certain transactions (e.g. those with illiquid collateral or margin call disputes);

    (c) exclusion of re-securitization exposures as collateral for capital adequacy purposes;

    (d) higher supervisory haircuts for securitization exposures (other than re-securitization exposures); and

    (e) stricter treatments for transactions with wrong-way risk.

99. <u>The HKMA also proposes to clarify the capital treatment of certain repo-style transactions under the current framework. The HKMA proposes to make it clear that for repo, securities lending and securities borrowing (with securities as collateral) transactions a default risk capital charge should be calculated (in addition to the existing requirement for a capital charge to be calculated for the credit risk or market risk of the securities underlying the transactions).</u> No changes are needed in respect of reverse repo and securities borrowing (with cash as collateral) transactions, which are treated as collateralised loans under the current framework and, in respect of which, the existing capital treatment already addresses counterparty credit risk.

CVA capital charge

100. In respect of the calculation of the CVA capital charge referred to in paragraph 93, the HKMA proposes to make available both the advanced and standardised methodologies devised by the Basel Committee. AIs with supervisory approval to use the IMM for their default risk and specific interest rate risk capital calculations will be required to use the advanced methodology while all other banks will be required to use the standardised methodology.

CCR framework for transactions with CCPs

101. Assuming the Basel Committee's final rules are in conformity with the outline above, the HKMA would propose to adopt them as part of its Basel III implementation package.

Section 3

Integration of Pillar 2 under Basel III

102. This section sets out the HKMA's proposals concerning the integration of the Pillar 2 process into the Basel III framework.

103. The Basel III capital framework focuses primarily on Pillar 1 requirements and does not provide specific guidance on the application of the Pillar 2 capital requirements in the context of the new risk-weighted capital ratios and capital buffers.

104. Although there has been some discussion at the Basel Committee's Standards Implementation Group, no international consensus has yet emerged on how Pillar 2 should be integrated into the Basel III framework. The approach taken in addressing this issue will obviously affect individual AIs' capital planning needs, and the HKMA therefore considers it important to consult the industry at an early stage on its current thinking in this area. The HKMA will continue to monitor international developments, including approaches adopted by other supervisors in major financial centres, and will assess the implications for the approach adopted or to be adopted in Hong Kong.

105. The guiding principles underpinning the HKMA's current thinking are that:

    (i) amid international efforts to strengthen banking resilience through higher capital standards, the fundamental concept of Pillar 2 should remain as important under Basel III as it is under Basel II, meaning that changes which may potentially weaken the existing Pillar 2 framework in Hong Kong should not be introduced; and

    (ii) any approach to integration should not result in a disproportionate capital impact on AIs.

Pillar 2 capital requirements as part of minimum regulatory capital ratios

106. <u>The HKMA proposes to maintain the basic concept of the existing Pillar 2 framework, that is the Pillar 2 risks of a locally incorporated AI will be covered by a capital "add-on" as part of its minimum capital requirements.</u> This is to ensure that AIs have sufficient capital to cover not only Pillar 1 risks (credit,

market and operational) but also other Pillar 2 risks that are not covered, or not adequately covered, under Pillar 1. The Pillar 2 risks include risks, such as credit concentration risk, interest rate risk in the banking book, reputation risk and strategic risk, that are less quantifiable, but no less important, than the Pillar 1 risks. Further discussion on how the Pillar 2 add-on will be incorporated into the three minimum Basel III capital ratios can be found in paragraph 111.

Relationship between Pillar 2 capital requirements and Basel III capital buffers

107. Under Basel III, the two capital buffers (the capital conservation buffer and countercyclical capital buffer) are intended to promote capital conservation and build up capital defences in periods of excess credit growth, thereby increasing the resilience of the banking sector in times of stress and minimising destabilising effects to the sector or to the wider economy. While the HKMA envisages that the extent of overlap between the existing Pillar 2 calibration (which mainly caters for institution-specific banking risks covered under the Pillar 2 scoring system) and the buffers (which largely emanate from broader overall resilience, macro-prudential and systemic concerns) should not be significant, the HKMA intends to review the Pillar 2 framework to identify and adjust any risk factors that may already be accounted for, to some extent, within the buffers.

108. As the HKMA's current intention is to follow the Basel Committee's transitional timeline for implementing the buffers, the timing of any Pillar 2 adjustment as a result of the above review will be synchronised with the implementation of the buffers (i.e. starting from 2016).

Pillar 2 capital requirements - calibration

109. Section 101 of the Banking Ordinance provides for the HKMA, after consultation, to vary an AI's capital adequacy ratio by increasing it to not more than 16%. With the minimum Pillar 1 requirement set at 8%, this effectively means that the maximum size of the Pillar 2 add-on for locally incorporated AIs is 8%. The Banking (Amendment) Bill 2011, which was introduced into the Legislative Council in December 2011, provides for the HKMA to set and vary capital requirements for locally incorporated AIs[26]. No upper limit for variation is specified. This point was discussed in the papers sent to the industry associations on 13 October 2011 concerning "Basel III implementation – Consultation on proposed amendments to the Banking Ordinance" (see paragraph 3.11 of Annex 2 to the HKMA's letter of that date). Broadly, the HKMA takes the view that if (i) capital is required on reasonable grounds, to maintain a capital base consistent with what is sound and prudent, taking into account the risks associated with the AI; and (ii) the HKMA must be satisfied, on reasonable grounds, that it is prudent to make a variation of an individual AI's capital requirements; (both of these elements are specifically reflected in the Bill), there is no justification for an arbitrary limit. Furthermore, Basel III sets no such upper limit. To alleviate to some degree any industry concerns on the removal of the upper limit, the HKMA's power to vary capital requirements is subject to a set of checks and balances, set out in the Bill, to ensure adequate consultation and opportunity for AIs to make representations.

110. Notwithstanding the proposed removal of the 16% upper limit, the HKMA does not expect major increases in individual AIs' Pillar 2 requirements when Basel III is implemented, provided that there are no significant changes in their overall risk profiles. Subject to the findings of the Pillar 2 review referred to in paragraph 107, <u>the HKMA proposes to adopt, in general, the existing framework for the calibration of the Pillar 2 add-on under Basel III.</u>

Allocation of Pillar 2 capital requirements

111. Locally incorporated AIs will be subject to three minimum risk-weighted capital ratios under Basel III, i.e. the CET1 Capital Ratio of 4.5%, the Tier 1 Capital Ratio of 6%, and a Total Capital Ratio of 8%, when all of the ratios are fully

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[26] The capital requirements will include the CET1 Capital, AT1 Capital and Tier 2 Capital ratios, the capital buffers and the leverage ratio.

implemented in 2015. As the Pillar 2 add-on will form part of an AI's minimum capital requirements (see paragraph 106), a decision needs to be taken as to whether the Pillar 2 add-on should take the form of CET1 Capital only, or a mix of CET1 Capital and AT1 Capital, or a mix of all of CET1 Capital, AT1 Capital and Tier 2 Capital. The HKMA is minded to adopt a consistent basis between Pillar 1 and Pillar 2 and proposes to allocate the Pillar 2 add-on to the three capital ratios in accordance with the 4.5% / 6% / 8% split under Pillar 1. So, for example, an AI's minimum CET1 Capital Ratio to its minimum Total Capital Ratio (with the Pillar 2 add-on incorporated) will be 56.25% (i.e. 4.5% / 8%) and if the AI's Pillar 2 add-on is 2%, its minimum CET1 Capital Ratio, Tier 1 Capital Ratio and Total Capital Ratio will respectively be 5.625%, 7.5% and 10%.[27]

112. While the above allocation method is consistent with the Pillar 1 Capital split, there is a disadvantage insofar as the approach will necessitate AIs re-calculating the Pillar 2 allocation whenever there is any change in the size of their Pillar 2 add-on, or any change in the Pillar 1 split during the phase-in period.[28] AIs will also need to closely monitor, plan for and address any potential or resultant increases in capital by type (i.e. CET1 and AT1 and Tier 2 capital instruments). The HKMA would be interested to hear from the industry as to whether, from AIs' perspective, this additional complexity outweighs the benefits of a split allocation approach and whether the simplicity offered by requiring that the Pillar 2 add-on be constituted entirely of CET1 Capital would be preferred.

113. Ideally, from a purely prudential standpoint, it would be desirable for the Pillar 2 add-on to consist largely, or wholly, of capital with the highest loss-absorbing power (i.e. common equity).[29] The HKMA, however, has some residual concern that this method of allocation may create undue strain on capital-raising (taking into account the fact that the two capital buffers must also be constituted by common equity). The HKMA has therefore, on balance, opted for the proposed allocation approach outlined above, but the HKMA proposes to reserve the right to vary the allocation method for individual AIs on a case-by-case basis should supervisory concerns regarding the risk profile of a given AI so warrant.

[27] 5.625% = 4.5% + 1.125% (i.e. 4.5% / 8% x 2%); 7.5% = 6% + 1.5% (i.e. 6% / 8% x 2%); 10% = 8% + 2%

[28] During the phase-in period, the split will be 3.5% / 4.5% / 8% for 2013 and 4% / 5.5% / 8% for 2014.

[29] For example, Australia is proposing the Pillar 2 add-on to comprise only Tier 1 capital.

114. In finalising the allocation approach, the HKMA will obviously take into account comments received in this consultation and will also have regard to any prevalent approach adopted (or likely to be adopted) by other supervisors in major financial centres.

Order of application of common equity

115. The common equity held by an AI is required to meet the new minimum capital ratios and the two buffers under Basel III. The HKMA's proposes to adopt the following order of application of the common equity held by AIs:

Order	Capital requirement
1	CET1 Capital Ratio
2	Tier 1 Capital Ratio
3	Total Capital Ratio
4	Capital Conservation Buffer + Countercyclical Capital Buffer

116. This is in line with the Basel III rules which indicate that common equity must first be used to meet the minimum capital requirements before the remainder can contribute to the capital conservation buffer.[30] For the purpose of applying the common equity held by an AI, the countercyclical capital buffer will be combined with the capital conservation buffer and treated as one single buffer.

Positioning of Pillar 2 within the hierarchy of the capital ladder

117. On the premise that the Pillar 2 add-on will continue to form a part of the minimum capital requirements, the HKMA proposes to adopt the following hierarchy which is also consistent with the existing Pillar 2 framework:

[30] See footnote 47 of the revised Basel III capital rules text as of June 2011.

Building block	**Components**	**Remarks**
Minimum capital ratios	• CET1 Capital Ratio (Pillar 1+ Pillar 2) • Tier 1 Capital Ratio (Pillar 1+Pillar 2) • Total Capital Ratio (Pillar 1+Pillar 2)	• All ratios (including the AI-specific Pillar 2 add-on) must be met at all times
Capital buffers	• Capital Conservation Buffer (in common equity) • Countercyclical Capital Buffer (in common equity)	• Falling below the buffer levels will render AIs subject to restrictions (e.g. reducing distribution of earnings)
Non-statutory trigger(s)	• [x%] above the minimum capital ratios and buffers in force [31]	• A monitoring tool to facilitate early intervention re prospective failure to comply with the capital requirements

118. A potential issue in adopting the above approach is that it could conceivably result in effective disclosure of an AI's Pillar 2 capital requirement in the event that the AI's capital position falls within the buffer zone (thus triggering distribution restrictions). At present an AI's Pillar 2 add-on is not disclosed publicly. In practice the likelihood of disclosure may be less than otherwise apparent as AIs will likely manage their capital positions to internal capital targets at a level slightly above the trigger ratio.

119. The HKMA would be interested to hear from the industry whether the industry has any suggestions on how concerns on disclosure of the Pillar 2 add-on might be mitigated or whether the potential for such disclosure is indeed a significant concern.

Implementation and transitional arrangements

120. The application of the Pillar 2 approach outlined above, will come into effect from 1 January 2013 for all locally incorporated AIs. <u>The HKMA proposes to determine the three minimum capital ratios applicable to each AI on 1 January</u>

[31] The HKMA does not envisage any significant change to the current risk-based approach to assigning a non-statutory trigger ratio to individual AIs. In practice the magnitude of the trigger ratio is at least 0.5%.

2013 by reference to the minimum CAR (and hence the Pillar 2 add-on) of the AI immediately in force before that date. This grandfathered minimum CAR (and the two other minimum capital ratios derived from it as proposed under paragraph 111) will continue in force until otherwise advised by the HKMA, as a result of the supervisory review process conducted on individual AIs after 1 January 2013 based on the prevailing Pillar 2 framework.

Further issues to be considered

121. The extent to which, if at all, the surcharge for global systemically important banks (G-SIBs) will affect the Pillar 2 framework under Basel III will be determined, taking into account the relevant assessment methodology and framework issued by the Basel Committee. Generally speaking, the surcharge for G-SIBs can be regarded as a measure to reduce the risks posed by such banks to the global financial system[32] rather than the risks taken on by them, and it will form part of their capital buffers. In view of this, the HKMA considers that any overlap between the surcharge and the Pillar 2 framework is unlikely to be significant.

122. With the implementation of the Basel III liquidity standards, the liquidity risk assessment factors in the Pillar 2 capital framework will need to be reviewed. Some of these factors may more appropriately be incorporated into supervisory assessments of individual AIs' liquidity positions (i.e. whether an AI assuming an exceptionally high level of liquidity risk might warrant an additional liquidity buffer) once the new Liquidity Coverage Ratio is implemented in 2015.

123. Subject to industry feedback, the HKMA plans to conduct a full review of the Pillar 2 framework with a view to making any necessary modifications in the first half of 2012 to prepare for implementation by AIs on 1 January 2013. These modifications will be incorporated into the SPM module "Supervisory Review Process" (CA-G-5) and the industry will be consulted in due course.

[32] One overarching objective of the G-SIB policy measures is to reduce the negative externalities caused by the distress or default of a G-SIB, by reducing both the probability of default and the loss to society given default.

Section 4

Implementation timetable

124. As noted in paragraph 9, the HKMA intends to follow the transitional timeline set by the Basel Committee for implementing the Basel III capital standards in Hong Kong. Generally speaking, locally incorporated AIs should be relatively well-placed to meet the new capital requirements as they have tended to be conservative in their capital management, holding capital in excess of the minimum required levels and placing significant reliance on common equity as a constituent of their capital base. Consideration has therefore been given as to whether the Basel III capital standards should be adopted in Hong Kong in advance of the Basel Committee's transitional timeline. However, in view of the present uncertainties affecting the markets and economies in many jurisdictions and the potential spillovers and effects on global growth, the HKMA's current thinking is to adopt a "steady as we go" approach.

125. Following the Basel Committee's transitional timeline should ensure that AIs are able to meet the new standards through reasonable earnings retention, capital or fund raising, and other balance sheet adjustments, while continuing to support economic activity through lending and other banking business. For ease of reference, the transitional timeline which the HKMA proposes to adopt for (i) phasing-in the minimum capital requirements, capital buffers and new capital deductions, and (ii) phasing-out capital instruments and minority interests that are no longer eligible for inclusion in the capital base is set out in **Annex 7**.

126. The HKMA will continue to monitor the approaches taken to the adoption of the Basel III capital standards in other major financial centres, including the timeline for adoption, and should there be significant negative implications for Hong Kong (for example in terms of any suggestion that the capital positions of AIs in Hong Kong are becoming relatively weaker as banks in early implementing jurisdictions strengthen their capital bases) the HKMA may revisit its approach and consider whether early implementation of some aspects of the Basel III package may be warranted in light of prevailing circumstances (including the level and trend of AI's capital positions at the relevant time).

Annex 1

Criteria for classification as ordinary shares for regulatory capital purposes

1. Represents the most subordinated claim in liquidation of the bank.

2. Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).

3. Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).

4. The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.

5. Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).

6. There are no circumstances under which the distributions are obligatory. Non payment is therefore not an event of default.

7. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.

8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur[33]. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others.

9. The paid in amount is recognized as equity capital (i.e. not recognized as a liability) for determining balance sheet insolvency.

10. The paid in amount is classified as equity under the relevant accounting standards.

11. It is directly issued and paid-in and the bank can not directly or indirectly have funded the purchase of the instrument.

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[33] In cases where capital instruments have a permanent write-down feature, this criterion is still deemed to be met by common shares.

12. The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity[34] or subject to any other arrangement that legally or economically enhances the seniority of the claim.

13. It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners.

14. It is clearly and separately disclosed on the bank's balance sheet.

[34] A related entity can include a parent company, a sister company, a subsidiary or any other affiliate. A holding company is a related entity irrespective of whether it forms part of the consolidated banking group.

Annex 2

Criteria for inclusion in Additional Tier 1 Capital

1. Issued and paid-in.

2. Subordinated to depositors, general creditors and subordinated debt of the bank.

3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors.

4. Is perpetual, i.e. there is no maturity date and there are no step-ups or other incentives to redeem.

5. May be callable at the initiative of the issuer only after a minimum of five years:
   (a) to exercise a call option a bank must receive prior supervisory approval; and
   (b) a bank must not do anything which creates an expectation that the call will be exercised; and
   (c) banks must not exercise a call unless:
      (i) they replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank[35]; or
      (ii) the bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised[36].

6. Any repayment of principal (e.g. through repurchase or redemption) must be with prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given.

7. Dividend / coupon discretion:
   (a) the bank must have full discretion at all times to cancel distributions / payments[37]
   (b) cancellation of discretionary payments must not be an event of default
   (c) banks must have full access to cancelled payments to meet obligations as they fall due
   (d) cancellation of distributions / payments must not impose restrictions on

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[35] Replacement issues can be concurrent with but not after the instrument is called.

[36] Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.

[37] A consequence of full discretion at all times to cancel distributions/payments is that "dividend pushers" are prohibited. An instrument with a dividend pusher obliges the issuing bank to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term "cancel distributions/payments" means extinguish these payments. It does not permit features that require the bank to make distributions/payments in kind.

the bank except in relation to distributions to common stockholders.

8. Dividends / coupons must be paid out of distributable items.

9. The instrument cannot have a credit sensitive dividend feature, that is a dividend / coupon that is reset periodically based in whole or in part on the banking organization's credit standing.

10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.

11. Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:
    (a) reduce the claim of the instrument in liquidation;
    (b) reduce the amount re-paid when a call is exercised; and
    (c) partially or fully reduce coupon / dividend payments on the instrument.

12. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

13. The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.

14. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity[38] or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.

[38] An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

Annex 3

Capital Conservation Buffer

In order to increase the resilience of the banking system and to address procyclicality to some degree, the Basel Committee has introduced a capital conservation buffer as an integral part of the Basel III capital reform package. The capital conservation concept requires banks to build-up and hold a buffer of CET1 Capital in excess of the minimum CET1 Capital ratio.

The "buffer zone" is equal to 2.5% of a bank's risk-weighted assets. Capital distribution constraints are imposed on the bank when its CET1 Capital ratio falls within the buffer zone. The constraints increase as the bank's capital level approaches the minimum CET1 requirement.

The table below sets out the percentages of the bank's earnings which it must conserve (i.e. cannot distribute) at various levels of CET1 Capital ratio within the buffer zone.

Individual bank minimum capital conservation standards	
CET1 ratio	**Minimum capital conservation ratios (expressed as a % of earnings)**
4.5% to 5.125%	100%
> 5.125% to 5.75%	80%
> 5.75% to 6.375%	60%
> 6.375% to 7.0%	40%
> 7.0%	0%

By way of example, a bank with a CET1 Capital ratio in the range of 5.125% to 5.75% must conserve 80% of its earnings in the next financial year (i.e. payout no more than 20% in dividends, share buybacks and discretionary bonus payments).

The capital conservation buffer will be phased-in between 1 January 2016, becoming fully implemented by 1 January 2019.

Annex 4

Criteria for inclusion in Tier 2 Capital

1. Issued and paid-in.

2. Subordinated to depositors and general creditors of the bank.

3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general bank creditors.

4. Maturity:
   (a) minimum original maturity of at least five years
   (b) recognition in regulatory capital in the remaining five years before maturity will be amortised on a straight line basis
   (c) there are no step-ups or other incentives to redeem.

5. May be callable at the initiative of the issuer only after a minimum of five years:
   (a) to exercise a call option a bank must receive prior supervisory approval;
   (b) a bank must not do anything that creates an expectation that the call will be exercised[39]; and
   (c) banks must not exercise a call unless:
      (i) they replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank[40]; or
      (ii) the bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised[41].

6. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.

7. The instrument cannot have a credit sensitive dividend feature, that is a dividend / coupon that is reset periodically based in whole or in part on the banking organization's credit standing.

8. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

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[39] An option to call the instrument after five years but prior to the start of the amortisation period will not be viewed as an incentive to redeem as long as the bank does not do anything that creates an expectation that the call will be exercised at this point.

[40] Replacement issues can be concurrent with but not after the instrument is called.

[41] Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.

9. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital.

<u>Annex 5</u>

Illustrative examples –
Computation of eligible minority interests to be included in an authorised institution's capital base

The case:
A banking group consists of two legal entities – **Bank P** is the parent and **Bank S** is the subsidiary. Their individual balance sheets are set out below.

Bank P – Balance sheet		**Bank S – Balance sheet**	
<u>Assets</u>		**<u>Assets</u>**	
Loans to customers	100	Loans to customers	160
CET1 investments in Bank S	*14*		
AT1 investments in Bank S	*4*		
Tier 2 investments in Bank S	*2*		
<u>Liabilities and equity</u>		**<u>Liabilities and equity</u>**	
Deposits	70	Deposits	127
TIER 2 capital instruments	10	*CET1 capital instruments*	*20*
AT1 capital instruments	7	*AT1 capital instruments*	*5*
CET1 capital instruments	26	*Tier 2 capital instruments*	*8*

The ownership of **Bank S**'s capital is distributed as follows: **Bank P** owns 70% of the common equity, 80% of the AT1 Capital and 25% of the Tier 2 Capital of **Bank S**.

Capital issued by Bank S					
	Amount issued to Bank P		**Amount issued to third parties**		**Total**
CET1	14	*70%*	6	*30%*	20
AT1	4	*80%*	1	*20%*	5
Tier 1	***18***		***7***		***25***
Tier 2	2	*25%*	6	*75%*	8
Total capital	***20***		***13***		***33***

(A) ***Minority interests arising from ordinary shares issued by a consolidated bank subsidiary***

Step 1 –
Calculate the surplus CET1 Capital of Bank S in excess of its 7% minimum CET1 Capital plus capital conservation buffer requirement (i.e. 4.5% + 2.5%). Bank S is assumed to have risk weighted assets of 100.

Minimum and surplus capital of Bank S		
	Minimum plus capital conservation buffer	**Surplus capital**
CET1	7.0 (= 7% * 100)	13 (= 20 – 7)

Step 2 –
Calculate the eligible portion of minority interest (MI) arising from CET1 Capital issued by Bank S that is allowed to be included in the consolidated capital of Bank P (i.e. item (e)).

Bank S: amount of capital issued to third parties included in consolidated capital					
	Total amount issued (a)	**Amount issued to third parties (b)**	**Surplus capital (c)**	**Surplus attributable to third parties (i.e. amount excluded from consolidated capital) (d) = (c) * (b)/(a)**	**Amount included in consolidated capital (e) = (b) – (d)**
CET1	20	6	13	3.90	2.10

Step 3 –
The eligible amount of MI to be included in the consolidated CET1 Capital of Bank P is 2.10.

	Total amount issued by Bank P (all of which is to be included in consolidated capital)	**Amount issued by Bank S to third parties to be included in consolidated capital of Bank P**	**Total amount issued by Bank P and Bank S to be included in consolidated capital of Bank P**
CET1	26	2.10	28.10

(B) Minority interests arising from ordinary shares and Additional Tier 1 capital instruments issued by a consolidated bank subsidiary

Step 1 –

Calculate the surplus Tier 1 Capital of Bank S in excess of its 8.5% minimum Tier 1 Capital plus capital conservation buffer requirement (i.e. 6% + 2.5%). Bank S is assumed to have risk weighted assets of 100.

Minimum and surplus capital of Bank S		
	Minimum plus capital conservation buffer	**Surplus capital**
Tier 1	8.5 (= 8.5% of 100)	16.5 (= (20 + 5) – 8.5)

Step 2 –

Calculate the eligible portion of MI arising from Tier 1 Capital issued by Bank S that is allowed to be included in the consolidated capital of Bank P (i.e. item (e)).

Bank S: amount of capital issued to third parties included in consolidated capital					
	Total amount issued (a)	**Amount issued to third parties (b)**	**Surplus capital (c)**	**Surplus attributable to third parties (i.e. amount excluded from consolidated capital) (d) = (c) * (b)/(a)**	**Amount included in consolidated capital (e) = (b) – (d)**
CET1	20	6	13	3.90	2.10
Tier 1	25	7	16.5	4.62	2.38

Step 3 –

The eligible amount for inclusion in Bank P's consolidated AT1 Capital is 0.28, arrived at by excluding from the eligible amount for inclusion as Tier 1 Capital (i.e. 2.38) the amount that has already been recognized in CET1 Capital (i.e. 2.10).

	Total amount issued by Bank P (all of which is to be included in consolidated capital)	**Amount issued by Bank S to third parties to be included in consolidated capital of Bank P**	**Total amount issued by Bank P and Bank S to be included in consolidated capital of Bank P**
CET1	26	2.10	28.10
AT1	7	0.28	7.28
Tier 1	***33***	***2.38***	***35.38***

(C) Minority interests arising from Tier 1 capital instruments and Tier 2 capital instruments issued by a consolidated bank subsidiary

Step 1 –
Calculate the surplus total capital of Bank S in excess of its 10.5% minimum total capital plus conservation buffer requirement (i.e. 8% + 2.5%). Bank S is assumed to have risk weighted assets of 100.

Minimum and surplus capital of Bank S		
	Minimum plus capital conservation buffer	**Surplus capital**
Tier 2	10.5 (= 10.5% of 100)	22.5 (= (20 + 5 + 8) – 10.5)

Step 2 –
Calculate the eligible portion of MI arising from total capital issued by Bank S that is allowed to be included in the consolidated capital of Bank P (i.e. item (e)).

Bank S: amount of capital issued to third parties included in consolidated capital					
	Total amount issued (a)	**Amount issued to third parties (b)**	**Surplus capital (c)**	**Surplus attributable to third parties (i.e. amount excluded from consolidated capital) (d) = (c) * (b)/(a)**	**Amount included in consolidated capital (e) = (b) – (d)**
CET1	20	6	13	3.90	2.10
Tier 1	25	7	16.5	4.62	2.38
Total capital	33	13	22.5	8.86	4.14

Step 3 –
The eligible amount for inclusion in Bank P's consolidated total capital is 1.76, arrived at by excluding from the eligible amount for inclusion as total capital (i.e. 4.14) the amount that has already been recognized in Tier 1 Capital (i.e. 2.38).

	Total amount issued by Bank P (all of which is to be included in consolidated capital)	**Amount issued by Bank S to third parties to be included in consolidated capital of Bank P**	**Total amount issued by Bank P and Bank S to be included in consolidated capital of Bank P**
CET1	26	2.10	28.10
AT1	7	0.28	7.28
Tier 1	***33***	***2.38***	***35.38***
Tier 2	10	1.76	11.76
Total capital	***43***	***4.14***	***47.14***

Annex 6

Pro forma structure of an authorised institution's capital base under Basel III

<table>
<tr><td rowspan="8">COMMON EQUITY TIER 1 (CET1)</td><td>(A)</td><td>Paid in ordinary share capital and share premium</td></tr>
<tr><td>(B)</td><td>Retained earnings</td></tr>
<tr><td>(C)</td><td>Other published reserves</td></tr>
<tr><td>(D)</td><td>Minority interest of common equity given recognition</td></tr>
<tr><td>(E)</td><td>CET1 capital before regulatory adjustments
(E) = (A) + (B) + (C) + (D)</td></tr>
<tr><td>(F)</td><td>Less : Regulatory adjustments --
- Fair value gains on revaluation of holdings of land and buildings
- Regulatory reserve for general banking risks
- Fair value gains or losses on revaluation of loans designated as AFS
- Cumulative fair value gains or losses in respect of cash flow hedges
- Fair value gains or losses on loans designated at fair value through profit or loss
- Cumulative gains and losses due to changes in own credit risk on fair valued liabilities
- Valuation adjustments
<u>Contingent items</u>:
- Goodwill, net of related deferred tax liability
- Intangibles, net of related deferred tax liability
- Deferred tax assets, net of related deferred tax liabilities
- Shortfall of provisions to expected losses (for exposures calculated by using IRB approach)
- Gain on sale on securitisation exposures
- Defined benefit pension fund assets
<u>Double-gearing items</u>:
- Investments in own shares
- Reciprocal cross holding in common equity
- Insignificant investments in the common stock of unconsolidated financial entities
- Significant investments in the common stock of unconsolidated financial entities
<u>Others</u>:
- Regulatory adjustments applied to CET1 due to insufficient AT1 and/or Tier 2 capital to cover deductions</td></tr>
<tr><td>(G)</td><td>CET1 capital after regulatory adjustments (G) = (E) – (F)</td></tr>
</table>

ADDITIONAL TIER 1 (AT1)	(H)	Additional Tier 1 capital instruments issued and share premium
	(I)	Minority interest of Additional Tier 1 capital instruments given recognition
	(J)	*Less: Regulatory adjustments --* ***Double-gearing items:*** - *Investments in own AT1 capital* - *Reciprocal cross holding in AT1 capital* - *Insignificant investments in AT1 capital of unconsolidated financial entities* - *Significant investments in AT1 capital of unconsolidated financial entities* ***Others:*** - *Regulatory adjustments applied to AT1 due to insufficient Tier 2 capital to cover deductions*
	(K)	**Tier 1 capital (K) = (G) + (H) + (I) – (J)**
TIER 2	(L)	Tier 2 capital instruments issued and share premium
	(M)	Minority interest of Tier 2 capital instruments given recognition
	(N)	Regulatory reserve for general banking risks subject to a limit
	(O)	Surplus provisions (for exposures calculated by using IRB approach)
	(P)	Fair value gains on revaluation of holdings of land and buildings subject to a haircut
	(Q)	*Less: Regulatory adjustments --* ***Double-gearing items:*** - *Investments in own Tier 2 capital* - *Reciprocal cross holding in Tier 2 capital* - *Insignificant investments in Tier 2 capital of unconsolidated financial entities* - *Significant investments in Tier 2 capital of unconsolidated financial entities*
	(Q)	**Total capital (Q) = (K) + (L) + (M) + (N) + (O) + (P) – (Q)**

Annex 7

Transitional Implementation Timetable

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Min CET1 capital ratio			**3.5%**	**4.0%**	**4.5%**	**4.5%**	**4.5%**	**4.5%**	**4.5%**
Capital conservation buffer (CSB)						**0.625%**	**1.25%**	**1.875%**	**2.5%**
Maximum countercyclical capital buffer (if imposed)						***[0.625%]***	***[1.25%]***	***[1.875%]***	***[2.5%]***
Min CET1 + CSB			**3.5%**	**4.0%**	**4.5%**	**5.125%**	**5.75%**	**6.375%**	**7.0%**
Min Tier 1 capital ratio			**4.5%**	**5.5%**	**6.0%**	**6.0%**	**6.0%**	**6.0%**	**6.0%**
Min Total Capital ratio	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**
Min Total Capital + CSB			**8.0%**	**8.0%**	**8.0%**	**8.625%**	**9.25%**	**9.875%**	**10.5%**
Capital instruments that no longer qualify as non-CET1 capital or Tier 2 capital			**Phased out over 10 year period starting 1.1.2013**						
Capital deductions from CET1 (same for AT1 and Tier 2) required under Basel III but not under current framework[42]			**0%**	**20%**	**40%**	**60%**	**80%**	**100%**	**100%**
			(The 5-year phase-in arrangement is applicable only to items that are not required to be deducted under the current regime)						
Minority interests not recognized under Basel III but recognized under current framework			**100%**	**80%**	**60%**	**40%**	**20%**	**0%**	**0%**

[42] Amount not deducted still subject to existing rules.