Appendix 2

PROPOSALS FOR
AMENDMENTS TO THE BANKING (CAPITAL) RULES TO ADDRESS CONCENTRATED SOVEREIGN EXPOSURES

Introduction

1 The following abbreviations are used in this document:

- "AI" means authorized institution as defined under the BO;
- "BCBS" means the Basel Committee as defined under the BO;
- "BO" means the Banking Ordinance (Cap. 155);
- "Capital Rules" means the Banking (Capital) Rules (Cap. 155L); and
- "MA" means the Monetary Authority.

2 Other expressions used in this document have the meaning given by section 2(1) of the Capital Rules.

3 A set of proposals to amend the Capital Rules to take into account the treatment of concentrated sovereign exposures are set out below comprising:

Part A Overview;

Part B Detailed proposals.

4 It should be noted that the proposed amendments in this document serve to supplement the implementation of the proposed Part 6 of the Banking (Exposure Limits) Rules.

PART A OVERVIEW

Purpose

1 The purpose of the proposed amendments is to insert a new Part in the Capital Rules to address the risk in concentrated sovereign exposure.

Background

2 The BCBS has effectively exempted exposures to (i) a sovereign; (ii) a central bank; and (iii) any public sector entity treated like a sovereign under the capital framework; from the normal large exposures limit relating to a single counterparty and a group of linked counterparties under the regime set out in the *Supervisory framework for measuring and controlling large exposures* issued in April 2014[1] by BCBS ("BCBS LE standards"). Nevertheless, in light of the fact that exposures to a sovereign (and entities connected to it) are not risk-free, certain jurisdictions have already proposed in their local implementation of the BCBS LE standards not to fully exempt exposures to sovereigns. For example, the US and Australia have proposed sovereign exposure limits which are linked to credit ratings.

3 Meanwhile, the BCBS is continuing to study the appropriate treatment of banks' credit concentration risk in sovereign entities. A discussion paper - *The regulatory treatment of sovereign exposures*[2] was issued in December 2017 by the BCBS collecting comments for further consideration. The discussion paper acknowledges that a bank may incur sovereign exposures for a spectrum of reasons, including regulatory requirements or to facilitate the implementation of central bank monetary policy. Given the sovereign exemption provided for in the BCBS LE standards, the discussion paper has proposed an alternative option to address banks' credit concentration risk in exposures to specified sovereign entities by including a risk-weighted amount for such exposures into the calculation of banks' regulatory capital under the capital framework.

4 In light of the fact that AIs may need to incur sovereign exposures for legitimate reasons, such as the deployment of funds into low-risk assets and to support the implementation of monetary policy, the HKMA is inclined to prefer the proposed alternative option referred to in the preceding paragraph (i.e. regulatory capital add-on) to that of setting a hard limit on sovereign exposures via the Banking (Exposure Limits) Rules. Accordingly, a decision has been made to address an

1 https://www.bis.org/publ/bcbs283.htm
2 https://www.bis.org/bcbs/publ/d425.htm

AI's risk in concentrated sovereign exposures by imposing a risk-weighted amount on such exposures (which will, in turn, result in increased capital requirements for AIs). It should be noted that in developing the amendments to the Capital Rules for this purpose, we have only adopted the main concepts underpinning, but not all the details of, the alternative option proposed in the discussion paper. Significant adaption will be made in order to (i) avoid the Capital Rules running counter to the BCBS LE standards and (ii) cater for the local environment. For example, the discussion paper covers subnational governments in the calculation of concentrated sovereign exposures but the BCBS LE standards do not exempt exposures to subnational governments. We adhere to the BCBS LE standards by not exempting subnational governments under the LE framework in the Banking (Exposure Limits) Rules and, accordingly, we do not propose to include subnational governments in the calculation of concentrated sovereign exposure under the proposed Capital Rules in order to avoid any "double-counting" or, as AIs will see it, "double penalty". Moreover, while the discussion paper suggests excluding exposures to central banks generally from the calculation of concentrated sovereign exposures, for local implementation purposes a decision has been made to make available the exclusion of central banks only in the case of the HKSAR and Mainland China.

5 As the scope of sovereign entities under the proposed revisions to the Capital Rules dealing with concentrated sovereign exposures will be different from the current definition of sovereign under section 2(1) of the existing Capital Rules, we intend to use the term "specified sovereign entities" in the revised rules to avoid confusion.

PART B DETAILED PROPOSALS

6 The following changes will be made under section 2(1) of the Capital Rules:

(a) Add a new definition along the following lines:

- ***risk-weighted amount for credit concentration risk,*** in relation to an authorized institution, means the total risk-weighted amount of the institution's exposures to credit concentration risk calculated in accordance with Part (number to be assigned to the new part referred to in paragraph 7).

(b) Amend the following definitions:

- ***Common Equity Tier 1 capital ratio*** will be amended to include the new risk-weighted amount, along the following lines--
  "in relation to an authorized institution, means, subject to sections 29, 30 and 31, the ratio, expressed as a percentage of the amount of the institution's CET1 capital to the sum of the institution's risk-weighted amount for credit risk, <u>risk-weighted amount for credit concentration risk</u>, risk-weighted amount for market risk and risk-weighted amount for operational risk, as determined in accordance with these Rules;".

- ***risk-weighted amount*** will be amended by the addition of a new paragraph (e) after paragraph (d) to include the new element for sovereign concentration risk along the following lines:
  "(e) in relation to the calculation of credit concentration risk of an authorized institution, means the amount of the institution's exposure to credit concentration risk calculated in accordance with Part (number to be assigned to the new part referred to in paragraph 7);".

- ***Tier 1 capital ratio*** will be amended to include reference to the new risk-weighted amount along the following lines--
  "in relation to an authorized institution, means, subject to sections 29, 30 and 31, the ratio, expressed as a percentage of the amount of the institution's Tier 1 capital to the sum of the institution's risk-weighted amount for credit risk, <u>risk-weighted amount for credit concentration risk</u>, risk-weighted amount for market risk and risk-weighted amount for operational risk, as determined in accordance with these Rules;".

- ***Total capital ratio*** will be amended to include reference to the new risk-weighted amount along the following lines--
  "in relation to an authorized institution, means, subject to sections 29, 30 and 31, the ratio, expressed as a percentage of the amount of the institution's Total capital to the sum of the institution's risk-weighted amount for credit risk, <u>risk-weighted amount for credit concentration risk</u>, risk-weighted amount for market risk and risk-weighted amount for operational risk, as determined in accordance with these Rules;".

<u>Insert new part</u>

7 A new Part is to be inserted in the Capital Rules to address credit concentration risk. [Remarks: (1) For the time being, credit concentration risk will only cover concentrated sovereign exposures.]

<u>Division 1 Interpretation</u>

8 The following definitions will be included in the new Part:

- ***Acceptable collateral*** means [see Remarks below]
  - (a) in relation to an AI that has been approved to use the BSC approach under section 6, collateral recognized under section 77, as if sections 77, 78, 79 and 80 were (i) applicable to the AI and (ii) the comprehensive approach referred to in section 77(h) and 77(i) was not available for use by the AI; and
  - (b) in relation to an AI that has not been approved to use the BSC approach under section 6, collateral recognized under section 77, as sections 77, 78, 79 and 80 apply to the AI or as if those sections were applicable to the AI, as the case may be;

  [Remarks –
  Under the Capital Rules, an AI is required to use the STC approach to calculate the credit risk capital charge (i.e. a default option) unless it applies and is approved by the MA to use another approach. The other approaches available are the BSC approach and IRB approach. The STC approach applies supervisory prescriptions while the IRB approach applies internal modelling to calculate the risk-weighted amount for credit risk. The BSC is a "home-grown" Hong Kong alternative to the STC approach and IRB approach made available under the Capital Rules locally to cater for the less sophisticated AIs. In other words, it is not an approach recognized in the Basel capital framework.

  Each, the STC approach, BSC approach and IRB approach carries its own criteria for recognizing collateral for credit risk mitigation purposes. The relevant sections setting out the criteria are as follows:
  - STC approach – Capital Rules sections 77 - 80;
  - BSC approach – Capital Rules sections 124 - 125;
  - IRB approach – Capital Rules sections 204 - 208.

  However, for the purpose of calculating the new credit concentration risk charge, all AIs (i.e. BSC, STC and IRB users) must use section 77 (which also makes reference to sections 78, 79 and 80) for the purpose of determining what qualifies as an acceptable collateral.

Under the STC approach, there are in turn two approaches to the treatment of collateral, i.e. the simple approach and the comprehensive approach. Section 78 provides for when to use which approach (i.e. simple or comprehensive) to the treatment of collateral. In gist, in relation to an exposure ("original exposure") protected by recognized collateral – (i) the simple approach involves substituting the risk weight of the original exposure by that of the issuer of the collateral to calculate the risk-weighted amount for credit risk for the proportion of the original exposure amount protected by the collateral; (ii) the comprehensive approach deducts an amount of collateral (adjusted by haircuts) from the original exposure and multiplies the remaining amount by the risk weight applicable to the original exposure to calculate the risk-weighted amount for credit risk of the protected exposure.

For the purposes of calculating the new credit concentration risk charge, an AI which applies the BSC approach must use the simple approach (under the STC approach) for the treatment of collateral [This is consistent with the current treatment that an AI which applies the BSC approach is only allowed to use the simple approach but not the comprehensive approach under Part 5 of the Capital Rules]. Other AIs (i.e. those using the STC approach or IRB approach) must use the simple approach or comprehensive approach (under the STC approach) according to section 78 for the treatment of collateral. This follows the guidance in the BCBS LE standards (paragraph 42).

For paragraph 8(b) above, reference to "has not been approved to use the BSC" is intended to include all STC and IRB users notwithstanding that they will not have sought approval from the MA to use the BSC approach under section 6 of the Capital Rules.]

- ***Acceptable guarantee*** means a guarantee recognized under section 98, as that section applies or as if that section was applicable to the AI, as the case may be.

[Remarks –

Similarly each, the STC approach, BSC approach and IRB approach carries its own criteria for recognizing guarantees for credit risk mitigation purposes. The relevant sections setting out the criteria are as follows:

- STC approach – Capital Rules section 98;
- BSC approach – Capital Rules section 132;
- IRB approach – Capital Rules sections 211-213.

However, for the purpose of calculating the new credit concentration risk charge, all AIs (i.e. BSC, STC and IRB users) must use section 98 for the purpose of determining what qualifies as an acceptable guarantee.]

- ***Concentrated sovereign exposure***, means the aggregate amount of specified sovereign exposures of an AI relating to a particular country other than the People's Republic of China and the Hong Kong Special Administrative Region, if the amount exceeds 100% of the Tier 1 capital of the AI;

[Remarks: (1) The policy intent is that concentrated sovereign exposure does not apply to the PRC and HKSAR. (2) By definition under section 2(1) of the Capital Rules, country includes (a) subject to (b), any part of a country; and (b) any jurisdiction except a restricted jurisdiction. For the purpose of calculating the new credit concentration risk charge, Macau is regarded as a separate country.]

- ***Specified sovereign entity***, in relation to a country other than the People's Republic of China and the Hong Kong Special Administrative Region, means any one of the following entities of the country –
  (a) the central government;
  (b) the central bank;
  (c) a sovereign foreign public sector entity;

[Remarks: under section 2(1) of the Capital Rules, a country includes (a) subject to (b), any part of a country and (b) any jurisdiction except a restricted jurisdiction. In brief a country includes the Hong Kong Special Administrative Region.]

- ***Specified sovereign exposure,*** in relation to an AI, means any of the following
  (a) an exposure to any specified sovereign entity;
  (b) an exposure covered by acceptable collateral issued by, or an acceptable guarantee given by, any specified sovereign entity,

that is measured according to Division 3.

Division 2 Calculation of risk-weight amount for credit concentration risk

9 An AI must calculate the amount representing the degree of credit concentration risk to which the AI is exposed as the sum of the risk-weighted amount of the AI's concentrated sovereign exposures for all countries.

[Remarks – For example, if an AI has concentrated sovereign exposures for countries A, B and C, it must sum the risk-weighted amounts for these 3 countries. The calculation of the risk-weighted amount for a country is provided for in paragraph 10. To avoid doubt, this risk-weighted amount for credit concentration risk is in addition to the risk-weighted amounts calculated under other parts of the Capital Rules.]

10 For calculating the amount in paragraph 9, an AI must calculate the risk-weighted amount of its concentrated sovereign exposure for a country by multiplying each portion of the exposure (measured in accordance with Division 3) as specified in the first row of the table below by the corresponding risk weight in the second row and aggregating the results.

[Remarks: for example, an AI has concentrated sovereign exposures with respect to country A amounting to $160 and its Tier 1 capital is $100. The required risk-weighted amount for country A is $100 x 0% + $50 x 5% + $10 x 6% = $3.1.]

First row	Portion of Concentrated sovereign exposure for a country (expressed as a percentage of Tier 1 capital)	0 to 100%	>100 to 150%	>150 to 200%	>200 to 250%	>250 to 300%	>300 %
Second row	Risk weight	0%	5%	6%	9%	15%	30%

Division 3 Valuation of specified sovereign exposures

General

11 The Capital Rules will include a division within the new part specifying how individual specified sovereign exposures are to be "valued" or measured. This division will provide that a specified sovereign exposure does not include:

(a) the amount of the exposure that has been deducted in determining the capital base of the institution in accordance with the Capital Rules;

(b) the amount of the exposure for which specific provisions have been made.

Exposure under paragraph (a) of the definition of specified sovereign exposure

12 The Capital Rules will provide that an AI must measure an exposure under paragraph (a) of the definition of specified sovereign exposure that is booked in its banking book according to the table below:

Exposure under paragraph (a) of the definition of specified sovereign exposure booked in the banking book

Approach used for calculating the credit risk for non-securitization exposures and securitization exposures	Exposure value		
	On-balance sheet exposure (other than counterparty default risk exposure)	Off-balance sheet exposure (other than counterparty default risk exposure)	Counterparty credit risk exposure (Note 1)
BSC approach / STC approach / IRB approach	current book value	Credit equivalent amount	• In relation to SFTs, amount of default risk exposure; • in relation to derivative contracts, amount of outstanding default risk exposure

Securitization internal ratings-based approach / securitization external ratings-based approach / securitization standardized approach / securitization fall back approach	The amount determined in accordance with section 235(1)	The amount determined in accordance with section 235(2)(b) or (c)	The amount determined in accordance with section 235(2)(a)

Note 1: (a) counterparty credit risk exposure does not include credit valuation adjustment.

13 For paragraph 12, counterparty credit risk exposure is deemed to be an exposure booked in the banking book, even if the contract from which the counterparty credit risk exposure is derived is booked in the institution's trading book.

14 The Capital Rules will provide that an AI must measure an exposure under paragraph (a) of the definition of specified sovereign exposure that is booked in its trading book according to the provisions below:

(a) a long position should be measured as the amount of loss that would be sustained by the institution if the obligor was to immediately default and a short position should be measured as the amount of gains to the institution if the obligor was to immediately default;

Examples:

Exposure	**Basis of exposure value**
Debt securities issued by a central government, central bank or sovereign foreign public sector entity	Current market value
Instruments such as swaps, futures and forwards with underlying issued by a central government, central bank or sovereign foreign public sector entity	Fair value of the exposure to the underlying of the instrument

(For an AI being the protection seller) Credit derivative contract with a central government, central bank or sovereign foreign public sector entity being the reference entity	The amount due in the case a credit event occurs, minus the absolute value of the credit protection
Options with underlying issued by a central government, central bank or sovereign foreign public sector entity	- Long call: V - Long put: −S+V - Short call: −V - Short put: S−V where S = strike price and V = fair value of the option contract.
Investment structure with underlying issued by a central government, central bank or sovereign foreign public sector entity	An exposure to the central government / central bank / sovereign foreign public sector entity is only required to be recognised if the current book value of the AI's holding of shares or units or other participation rights in the investment structure exceeds 0.25% of the AI's Tier 1 capital. In that case, the exposure value should be calculated by the following formula: $E(A) = \text{Min}\ (S_A \times NAV_{AI} / NAV_S), BV)$ Where E(A) = AI's exposure to central government / central bank/ sovereign foreign public sector entity issued underlying in an investment structure (asset A); S_A = The investment structure's exposure to asset A as disclosed in the latest financial reports of the investment structure; NAV_{AI} = Net asset value of the share of the AI's holding of the shares or units of the investment structure;

	NAV_S = Net asset value of the investment structure; BV = Current book value of the shares or units of the investment structure.

(b) AIs may offset long and short positions in the same issue of securities (two issues are regarded as the same if the issuer, coupon, currency and maturity are identical); [Remarks: securities should include shares of a company and bonds]

(c) Positions in different issues of securities issued by the same counterparty may be offset when the short position is junior to the long position, or if the positions are of the same seniority;

(d) For positions hedged by credit derivatives, the hedge may be recognised provided that the seniority of the underlying of the hedge is junior to the seniority of the position hedged;

(e) Offsetting positions in the trading book with positions in the banking book is not allowed;

(f) For the purposes of paragraphs (b) and (c), to determine the relative seniority of positions, securities may be allocated into broad buckets of degrees of seniority (for example, Equity, Subordinated Debt and Senior Debt);

(g) A net short position with a single counterparty is taken as zero.

<u>Exposure under paragraph (b) of the definition of specified sovereign exposure</u>

15 The Capital Rules will provide that an exposure under paragraph (b) of the definition of specified sovereign exposure is valued up to the amount of the acceptable collateral or acceptable guarantee, as the case may be.

<u>Implementation</u>

16 The above amendments to the Capital Rules are intended to come into operation on 1 January 2019.