

First draft (Second batch)

(re: Part 2 – Application of These Rules

Part 3 – Determination of Capital Base)

CAPITAL RULES

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CAPITAL RULES

(Made by the Monetary Authority under section 98A of the Banking Ordinance (Cap. 155)
as amended by the Banking (Amendment) Ordinance 2005)

PART 1

PRELIMINARY

1. Commencement

These Rules shall come into operation on a day to be appointed by the Secretary for Financial Services and the Treasury by notice published in the Gazette.

2. Interpretation

In these Rules, unless the context otherwise requires -

"available-for-sale" (), in relation to a financial asset or financial instrument, has the meaning assigned to it by Hong Kong Accounting Standard 39;

"basic approach" (), in relation to the calculation of an authorized institution's credit risk, means the method of calculating that risk set out in *Part 4*;

"book value" (), in relation to any thing, means the thing's current book value after deducting the amount of any allowance for impairment loss arising from an individual assessment of the thing for impairment loss in accordance with Hong Kong Accounting Standard 39;

"cash flow hedge" () means the hedging relationship defined in paragraph 86 of Hong Kong Accounting Standard 39;

"collective provisions" (), in relation to the on-balance sheet assets of an authorized institution, means an allowance for impairment loss arising from a collective assessment of the assets for impairment loss in accordance with Hong Kong Accounting Standard 39;

"connected company" (), in relation to an authorized institution, means -

- (a) a subsidiary, or the holding company, of the institution; or
- (b) a company which falls within section 64(1)(b), (c), (d) or (e) of the Ordinance in respect of the institution;

"consolidated basis" (), in relation to the calculation of an authorized institution's capital adequacy ratio, means the institution calculates that ratio on the basis set out in *section 13*;

"consolidation group" (), in relation to an authorized institution, means -

- (a) the institution; and
- (b) if the institution is the subject of -
 - (i) a section 98(2) requirement falling within *paragraph (a)* or *(c)* of the definition of "section 98(2) requirement", all the subsidiaries of the institution;
 - (ii) a section 98(2) requirement falling within *paragraph (b)* or *(d)* of the definition of "section 98(2) requirement", such subsidiaries of the institution as are specified in the requirement;

"consolidation requirement" (), in relation to a subsidiary of an authorized institution, means -

- (a) a section 79A(1) requirement whereby a provision of Part XV of the Ordinance is to apply to the institution on a consolidated basis in respect of that subsidiary; or
- (b) a section 98(2) requirement whereby the capital adequacy ratio of the institution is to be calculated on a consolidated basis in respect of that subsidiary;

"core capital" (), in relation to an authorized institution, means the sum, calculated in Hong Kong dollars, of the book values of the institution's capital items specified in *section 17*;

"debentures" () means debentures within the meaning of section 2(1) of the Companies Ordinance (Cap. 32);

"dilution risk" (), in relation to a receivable purchased by an authorized institution, means the possibility that the amount of the receivable is reduced through cash or non-cash credits to the receivable's obligor;

"EAD" () means exposure at default;

"EL" () means expected loss;

"EL amount" (), in relation to an exposure of an authorized institution, means the expected loss amount of the exposure calculated by multiplying the EL of the exposure by the EAD of the exposure;

"eligible provisions" (), in relation to an authorized institution which uses the IRB to calculate its credit risk, means the sum of -

- (a) the institution's regulatory reserves for general banking risks, specific provisions, partial write-offs and collective provisions that are attributed to exposures which are subject to the IRB; and
- (b) any discounts on exposures referred to in *paragraph (a)* which are in default;

"eligible subsidiary" (), in relation to the calculation of an authorized institution's capital adequacy ratio, means a subsidiary which falls within *section 10(2)*;

"EP" () means eligible provisions;

"equivalent subordinated debt" () means a capital instrument specified in a notice under *subsection (2)(a)* to be equivalent, for the purposes of these Rules, to subordinated debt referred to in *paragraph (a)* of the definition of "other regulatory capital instrument";

"expected loss" (), in relation to an exposure of an authorized institution which uses the IRB to calculate its credit risk, means the expected loss on the exposure arising from the potential default of the obligor or dilution in respect of the exposure over a one year period relative to the EAD of the exposure;

"exposure at default" (), in relation to an exposure of an authorized institution which uses the IRB to calculate its credit risk, means the expected amount of the exposure -

- (a) upon the default of the obligor in respect of the exposure; and
- (b) measured gross of specific provisions and partial write-offs;

"fair value" () -

- (a) in relation to an asset, means the amount for which the asset could be exchanged between knowledgeable, willing parties in an arm's length transaction;
- (b) in relation to a liability, means the amount for which the liability could be settled between knowledgeable, willing parties in an arm's length transaction;

"forecast transaction" () has the meaning assigned to it by paragraph 9 of Hong Kong Accounting Standard 39;

"incorporated" () includes established;

"guarantee" () includes an indemnity;

"insurance firm" () -

(a) means an entity -

(i) authorized and supervised by a relevant insurance regulator pursuant to the law of a country other than Hong Kong; and

(ii) which is subject to supervisory arrangements regarding the maintenance of adequate capital to support its business activities comparable to those prescribed for authorized institutions under the Ordinance and these Rules; and

(b) includes an authorized insurer within the meaning of the Insurance Companies Ordinance (Cap. 41);

"insurance regulator" () does not include a restricted insurance regulator;

"irredeemable" (), in relation to non-cumulative preference shares, means that the shares are -

(a) irredeemable; or

(b) irredeemable except with the prior consent of the Monetary Authority;

"loans designated as available-for-sale" (), in relation to an authorized institution, means the loans that the institution upon initial recognition designates as available-for-sale in accordance with Hong Kong Accounting Standard 39;

"other regulatory capital instrument" () means -

- (a) subordinated debt -
 - (i) issued by an authorized institution incorporated in Hong Kong; and
 - (ii) included in the institution's supplementary capital; or
- (b) a capital instrument -
 - (i) issued by a company which is not an authorized institution incorporated in Hong Kong but which is -
 - (A) subject to supervision by a financial regulator; and
 - (B) subject to capital requirements imposed on it in the country in which the financial regulator is such financial regulator; and
 - (ii) which is similar to subordinated debt falling within *paragraph (a)*;

"PD/LGD approach" (), in relation to an equity exposure of an authorized institution, means the use of the IRB to calculate the institution's credit risk in respect of equity exposures as specified in *section [..]*;

"restricted insurance regulator" () means an insurance regulator specified in *Part [..] of Schedule 1A*;

"securities not held for trading purposes" (), in relation to an authorized institution, means securities -

- (a) held by the institution other than those which are acquired principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

- (b) designated by the institution as securities not held for trading purposes;

"section 98(2) requirement" (), in relation to an authorized institution, means a requirement in a notice under section 98(2) of the Ordinance whereby the capital adequacy ratio of the institution is to be calculated on -

- (a) a consolidated basis in respect of all the subsidiaries of the institution;
- (b) a consolidated basis in respect of such subsidiaries of the institution as are specified in the notice;
- (c) the consolidated basis referred to in *paragraph (a)* and an unconsolidated basis; or
- (d) the consolidated basis referred to in *paragraph (b)* and an unconsolidated basis unless otherwise specified in the notice;

"section 79A(1) requirement" (), in relation to an authorized institution, means a requirement in a notice under section 79A(1) of the Ordinance whereby a provision of Part XV of the Ordinance is to apply to the institution on -

- (a) a consolidated basis in respect of all the subsidiaries of the institution;
- (b) a consolidated basis in respect of such subsidiaries of the institution as are specified in the notice;
- (c) the consolidated basis referred to in *paragraph (a)* and an unconsolidated basis; or

(d) the consolidated basis referred to in *paragraph (b)* and an unconsolidated basis unless otherwise specified in the notice;

"solo basis" (), in relation to the calculation of an authorized institution's capital adequacy ratio, means the institution calculates that ratio on the basis set out in *section 11*;

"solo-consolidated basis" (), in relation to the calculation of an authorized institution's capital adequacy ratio, means the institution calculates that ratio on the basis set out in *section 12*;

"solo-consolidated subsidiary" (), in relation to an authorized institution, means a subsidiary of the institution specified in an approval under *section 12(2)(a)* granted to the institution;

"special purpose vehicle" (), in relation to an authorized institution, means a company or other entity -

(a) established by the institution for the sole purpose of raising capital for the institution; and

(b) which does not trade or conduct any business except raising capital for the institution;

"specified amount" (), in relation to an authorized institution, means any amount that the institution is required under *section 23(2)* to deduct from its core and supplementary capital;

"SPV" () means a special purpose vehicle;

"subsidiary undertaking" () has the meaning assigned to it by the Twenty-third Schedule to the Companies Ordinance (Cap. 32);

"supplementary capital" (), in relation to an authorized institution,
means the sum, calculated in Hong Kong dollars, of the book value of the
institution's capital items specified in *section 18*;

"total EL amount" (), in relation to an authorized institution which uses
the IRB to calculate its credit risk, means the sum of the institution's EL amount
attributed to sovereign, bank, corporate and retail exposures of the institution
which are subject to the IRB;

"total EP" (), in relation to an authorized institution which uses the
IRB to calculate its credit risk, means the sum of the institution's eligible
provisions attributed to sovereign, bank, corporate and retail exposures of the
institution which are subject to the IRB;

"transitional period" () means the period commencing on and
including 1 January 2007 and ending on and including 31 December 2009.

PART 2

APPLICATION OF THESE RULES

Division 2 - Prescribed calculation approaches

3. Calculation of credit risk

An authorized institution shall -

- (a) subject to *paragraphs (b) and (c)*, only use the STC to calculate its credit risk;
- (b) subject to *paragraph (c)*, only use the BSA to calculate its credit risk if it has the approval to do so under *section 4(2)(a)*;
- (c) only use the IRB to calculate its credit risk if it has the approval to do so under *section 4(2)(a)*

4. Application by authorized institution for approval to use BSA or IRB to calculate its credit risk

(1) An authorized institution may make an application to the Monetary Authority for approval to calculate its credit risk by using the BSA or IRB.

(2) Subject to *subsection (3)*, the Monetary Authority shall determine an application under *subsection (1)* from an authorized institution by -

(a) granting approval to the institution to calculate its credit risk by using the BSA or IRB; or

(b) refusing to grant such approval.

(3) Without limiting the generality of *subsection (2)(b)*, the Monetary Authority shall refuse to grant approval to an authorized institution to use the BSA or IRB to calculate its credit risk if -

(a) in the case of the BSA, any one or more of the criteria specified in *section 5* applicable to or in relation to the institution are not fulfilled with respect to the institution;

(b) in the case of the IRB, any one or more of the criteria specified in *section 6* applicable to or in relation to the institution are not fulfilled with respect to the institution.

[(4) Provision not used.]

5. Minimum criteria for approval under *section 4(2)(a)* to use BSA to calculate credit risk of authorized institution

An authorized institution making an application under *section 4(1)* to use the BSA to calculate its credit risk must satisfy the Monetary Authority -

- (a) that -
 - (i) the institution and its consolidation group, if any, each had, at the end of the financial year immediately preceding the date of the application, total assets, before any specific and collective provisions, of not more than \$10 billion; and
 - (ii) there is no cause to believe that the use by the institution of the BSA to calculate its credit risk would not adequately identify, assess and reflect the credit risk of the institution's exposures taking into account the nature of the institution's business; or
- (b) that -
 - (i) the institution has an implementation plan for the use of the IRB to calculate its credit risk which, in form and substance, is adequate for that purpose; and
 - (ii) the institution is reasonably likely to fulfil, not later than the end of the transitional period, the criteria specified in *section 6* applicable to and in relation to an institution seeking to use the IRB to calculate its credit risk.

[6. Minimum criteria for approval under *section 4(2)(a)* to use IRB to calculate credit risk of authorized institution

An authorized institution making an application under *section 4(1)* to use the IRB to calculate its credit risk must satisfy the Monetary Authority that -

- (a)
- (b); and
- (c)]

7. Authorized institution shall not use BSA to calculate its credit risk after expiration of transitional period except on ground specified in *section 5(a)*

Subject to *section 9*, where approval under *section 4(2)(a)* has been granted to an authorized institution to use the BSA to calculate its credit risk on the ground specified in *section 5(b)*, then -

- (a) the institution may, during the transitional period, use the BSA to calculate its credit risk in respect of such exposures of the institution for which the institution does not have approval under *section 4(2)(a)* to calculate its credit risk using the IRB; and
- (b) the institution shall, immediately after the expiration of the transitional period, use the STC to calculate its credit risk in respect of such exposures of the institution for which the institution does not have approval under *section 4(2)(a)* to use the IRB to calculate its credit risk.

8. Provisions applicable where authorized institution may use combination of STC, BSA or IRB to calculate credit risk

(1) Where under these Rules an authorized institution may use more than one relevant approach to calculate its credit risk in respect of an exposure of the institution falling within a class of exposures of the institution, then the institution shall not -

- (a) use more than one such approach to calculate its credit risk in respect of all of its exposures falling within that class; or
- (b) discontinue using one such approach, and commence using another such approach, to calculate its credit risk in respect of all of its exposures falling within that class,

except with the prior consent of the Monetary Authority.

[(2) Where under these Rules an authorized institution which uses the IRB to calculate its credit risk may use more than one IRB recognized approach to calculate its credit risk in respect of an exposure of the institution falling within a class of exposures of the institution, then the institution shall not -

- (a) use more than one such IRB recognized approach to calculate its credit risk in respect of all of its exposures falling within that class; or
- (b) discontinue using one such IRB recognized approach, and commence using another such IRB recognized approach, to calculate its credit risk in respect of all of its exposures falling within that class,

except with the prior consent of the Monetary Authority.]

(3) In this section –

“relevant approach” (), in relation to the calculation of an authorized institution’s credit risk, means the STC, BSA or IRB;

["IRB recognized approach" () means -

- (a) in respect of corporate exposures, the foundation IRB, the advanced IRB or the supervisory slotting criteria approach;
- (b) in respect of sovereign exposures, the foundation IRB or the advanced IRB;
- (c) in respect of bank exposures, the foundation IRB or the advanced IRB;
- (d) in respect of retail exposures, the IRB; and
- (e) in respect of equity exposures, the simple risk-weight method or the internal models method under the market-based approach or the PD/LGD approach.]

9. Action that may be taken by Monetary Authority if authorized institution using BSA or IRB to calculate its credit risk no longer meets criteria specified in *section 5* [or *6*]

(1) Where -

- (a) an authorized institution uses the BSA or IRB to calculate its credit risk; and
- (b) the Monetary Authority is satisfied that, if the institution were to make a fresh application under *section 4(1)* for approval to use the BSA or the IRB, as the case may be, to calculate its credit risk, such approval would be refused by virtue of *section 4(3)*,

then the Monetary Authority may, by notice in writing given to the institution -

- (c) in the case of an institution using the BSA to calculate its credit risk, require the institution to use the STC to calculate its credit risk instead of the BSA -
 - (i) in respect of all of its business, or parts of its business, as specified in the notice; and
 - (ii) beginning on such date, or the occurrence of such event, as is specified in the notice;
- [(d) in the case of an institution using the IRB to calculate its credit risk -
 - (i) request the institution to -
 - (A) submit to the Monetary Authority a plan which satisfies the Monetary Authority that, if it were

implemented by the institution, would mean that the institution would rapidly cease to fall within *paragraph (b)*; and

- (B) implement such plan;
- (ii) require the institution, if it fails or refuses to comply with the request referred to in *subparagraph (i)*, to use the STC to calculate its credit risk instead of the IRB -
 - (A) in respect of all of its business, or parts of its business, as specified in the notice; and
 - (B) beginning on such date, or the occurrence of such event, as is specified in the notice;
- (iii) take one or more than one of the following measures until the institution ceases to fall within *paragraph (b)* -
 - (A) require the institution to calculate its credit risk by using the STC instead of the IRB -
 - (I) in respect of such parts of its business as are specified in the notice; and
 - (II) beginning on such date, or the occurrence of such event, as is specified in the notice;
 - (B) advise the institution that the Monetary Authority is considering exercising the Monetary Authority's power under *section 101* of the Ordinance to vary

the capital adequacy ratio of the institution by increasing it;

- (C) require the institution to be subject to a capital floor as specified in *section [..]*; or
- (D) require the institution to adopt such measures specified in the notice which, in the opinion of the Monetary Authority, will cause the institution to cease to fall within *paragraph (b)* or will otherwise mitigate the effect of the institution falling within that paragraph.

(2) An authorized institution shall comply with a requirement referred to in *subsection (1)(c) or (d)(ii) or (iii)(A), (C) or (D)* of a notice given to it under *subsection (1).*]

Division 4 - Solo, solo-consolidated and consolidated bases for calculation of capital adequacy ratio

10. Calculation of capital adequacy ratio on solo basis, solo-consolidated basis or consolidated basis

- (1) An authorized institution shall -
 - (a) use the solo basis to calculate its capital adequacy ratio or, if it has the approval to do so under *section 12(2)(a)*, use the solo-consolidated basis to calculate its capital adequacy ratio; and
 - (b) subject to *section 15*, use the consolidated basis to calculate its capital adequacy ratio covering risk-weighted amounts for all relevant risks of the consolidation group, if any.

(2) Subject to *section 15*, the Monetary Authority may in a section 98(2) requirement, require the capital adequacy ratio of an authorized institution to be calculated on a consolidated basis in respect of a subsidiary of the institution (other than a subsidiary which is an insurance firm or securities firm) where -

- (a) more than 50% of the total assets/total income of the subsidiary consist of the carrying out of one or more than one relevant financial activity; or

- (b) the Monetary Authority is satisfied that, after taking into account the nature of the business undertaken by the subsidiary, the institution must calculate its capital adequacy ratio on a consolidated basis in respect of that subsidiary if a relevant risk of the institution is to be adequately identified and assessed.

(3) In this section -

"relevant financial activity" (), in relation to a subsidiary of an authorized institution, means -

- (a) an activity which is ancillary to a principal activity of the institution, including -
 - (i) owning and managing the institution's property; and
 - (ii) performing information technology functions for the institution;
- (b) lending, including -
 - (i) the provision of consumer or mortgage credit;
 - (ii) factoring;
 - (iii) forfaiting; and
 - (iv) the provision of guarantees and other financial commitments;

- (c) financial leasing;
- (d) money transmission services;
- (e) issuing and administering a means of payment, including -
 - (i) credit cards;
 - (ii) travellers' cheques; and
 - (iii) bank drafts;
- (f) trading for the company's own account, or for accounts of the company's customers, in -
 - (i) money market instruments;
 - (ii) foreign exchange;
 - (iii) financial instruments which are traded on an exchange;
 - (iv) OTC derivative transactions; or
 - (v) transferable securities;
- (g) participating in securities issues, including the provision of services relating to the issues;
- (h) the provision of -

- (i) advice to undertakings on capital structure or industrial strategy, including any matter related to capital structure or industrial strategy; or
 - (ii) advice and services relating to mergers and the purchase of undertakings;
-
- (i) money broking; or
 - (j) portfolio management and the provision of advice in relation to portfolio management.

11. Solo basis for calculation of capital adequacy ratio

(1) An authorized institution shall in calculating its capital adequacy ratio on a solo basis -

- (a) aggregate the institution's (including the institution's local branches and overseas branches) risk-weighted amounts for -
 - (i) credit risk as calculated in accordance with *Division [..], [..]* or *[..]* of *Part 4*;
 - (ii) operational risk as calculated in accordance with *Division 1, 2 or 3* of *Part 5*; and
 - (iii) market risk as calculated in accordance with *Division [..]* or *[..]* of *Part 6*; and
- (b) determine the institution's capital base, in accordance with *Part 3*, to reflect the fact that it is calculating its capital adequacy ratio on a solo basis.

(2) For the avoidance of doubt, it is hereby declared that, for the purposes of this section, an authorized institution shall risk-weight the exposures of an overseas branch of the institution in accordance with the provisions of these Rules.

12. Solo-consolidated basis for calculation of capital adequacy ratio

(1) An authorized institution may make an application to the Monetary Authority for approval to calculate its capital adequacy ratio on a solo-consolidated basis instead of a solo basis in respect of such of its subsidiaries that are members of its consolidation group as are specified in the application.

(2) Subject to *subsection (3)*, the Monetary Authority shall determine an application under *subsection (1)* from an authorized institution by -

- (a) granting approval to the institution to calculate its capital adequacy ratio on a solo-consolidated basis instead of a solo basis in respect of such subsidiaries of the institution as are specified in the approval and giving the institution a section 98(2) requirement to give effect to such approval; or
- (b) refusing to grant such approval.

(3) Without limiting the generality of *subsection (2)(b)*, the Monetary Authority shall refuse to grant approval to an authorized institution to calculate its capital adequacy ratio on a solo-consolidated basis instead of a solo basis in respect of a subsidiary of the institution unless the institution satisfies the Monetary Authority that -

- (a) the subsidiary is wholly owned by, and managed as if it were an integral part of, the institution;

- (b) the subsidiary is wholly financed by the institution such that the subsidiary has no depositors or other external creditors except external creditors for -
 - (i) audit fees;
 - (ii) company secretarial services; and
 - (iii) sundry operating expenses; and
- (c) there are no regulatory, legal or taxation constraints on the transfer of the subsidiary's capital to the institution.

(4) Subject to *subsection (5)*, an authorized institution shall in calculating its capital adequacy ratio on a solo-consolidated basis -

- (a) aggregate the institution's (including the institution's local branches and overseas branches), and its solo-consolidated subsidiaries', risk-weighted amounts for -
 - (i) credit risk as calculated in accordance with *Division [..], [..]* or *[..]* of *Part 4*;
 - (ii) operational risk as calculated in accordance with *Division 1, 2, or 3* of *Part 5*; and
 - (iii) market risk as calculated in accordance with *Division [..]* or *[..]* of *Part 6*; and

(b) determine the institution's capital base, in accordance with *Part 3*, to reflect the fact that it is calculating its capital adequacy ratio on a solo-consolidated basis.

(5) An authorized institution which calculates its capital adequacy ratio on a solo-consolidated basis shall ensure that, in calculating that ratio, the risk-weighting of a relevant risk does not include inter-company balances with, and transactions between, the institution and its solo-consolidated subsidiaries.

(6) An authorized institution which has been granted an approval under *subsection (2)(a)* shall give notice in writing to the Monetary Authority -

(a) of the occurrence of any event ("relevant event") which could reasonably be construed as causing, or potentially causing, whether by itself or in conjunction with any other event, a subsidiary of the institution to fall outside paragraph (a), (b) or (c) of *subsection (3)*; and

(b) as soon as is practicable after the occurrence of the relevant event.

13. Consolidated basis for calculation of capital adequacy ratio

(1) An authorized institution shall in calculating its capital adequacy ratio on a consolidated basis -

- (a) aggregate the consolidation group's (including the institution's local branches and overseas branches) risk-weighted amounts for -
 - (i) credit risk as calculated in accordance with *Division [..], [..]* or *[..]* of *Part 4*;
 - (ii) operational risk as calculated in accordance with *Division 1, 2 or 3* of *Part 5*; and
 - (iii) market risk as calculated in accordance with *Division [..]* or *[..]* of *Part 6*; and]
- (b) determine the consolidation group's capital base, in accordance with *Part 3*, to reflect the fact that it is calculating its capital adequacy ratio on a consolidated basis.

(2) Subject to *section 13A*, it is hereby declared that, under the consolidated basis for the calculation of the capital adequacy ratio of an authorized institution, the institution shall ensure that -

- (a) the risk-weighting of a relevant risk does not relate to the exposures of a subsidiary of the institution which is not a member of the consolidation group; and

- (b) risk-weighting of a relevant risk does not include inter-company balances with, and transactions between, members of the consolidation group.

(3) An authorized institution which calculates its capital adequacy ratio on a consolidated basis shall give notice in writing to the Monetary Authority of -

- (a) the following matters -
 - (i) a subsidiary ceasing to be a subsidiary of the institution;
 - (ii) a new subsidiary of the institution;
 - (iii) the principal activities of a subsidiary referred to in *subparagraph (ii)*;
 - (iv) any significant change to the principal activities of the institution or any of its subsidiaries (including a subsidiary referred to in *subparagraph (ii)*); and
- (b) as soon as is practicable after the institution is aware of the matter or ought reasonably to be aware of the matter.

13A. Provisions supplementary to section 13

[(1) Provision not used.]

(2) With the prior consent of the Monetary Authority, an authorized institution which calculates its capital adequacy ratio on a consolidated basis may use the IRB, in combination with the STC or BSA, or both, to calculate its credit risk on that basis if -

- (a) the IRB will be so used for not less than -
 - (i) subject to *subparagraph (ii)*, 85% of the total credit risk-weighted exposures of the consolidation group calculated in accordance with [Part 4];
 - (ii) 75% of the total credit risk-weighted exposures of the consolidation group calculated in accordance with [Part 4] during the transitional period if *paragraph (a)* of *section 7* is applicable to the institution; and
- (b) it satisfies the Monetary Authority that it is not practicable for the IRB to be solely used to calculate the institution's credit risk on that basis.

(3) With the prior consent of the Monetary Authority, an authorized institution which calculates its capital adequacy ratio on a consolidated basis may use the IMA in combination with the STM to calculate its market risk on that basis if it satisfies

the Monetary Authority that it is not practicable for the IMA to be solely used to calculate the institution's market risk on that basis.

(4) An authorized institution which calculates its capital adequacy ratio on a consolidated basis may, insofar as its market risk is concerned -

- (a) net off balances between members of the consolidation group; and
- (b) offset market risk positions between members of the consolidation group,

if -

- (c) the market risk positions of the members are monitored and managed on a group basis;
- (d) there are no regulatory, legal or taxation constraints to mutual financial support between the members; and
- (e) there are no regulatory, legal or taxation constraints or the transfer of funds between the members.

(5) Where an authorized institution which calculates its capital adequacy ratio on a consolidated basis uses the BIA to calculate its operational risk, then -

- (a) subject to *paragraph (b)*, the institution may, in calculating the gross income of the consolidation group in any given year of the last 3 years, offset a positive gross income of a member of the

group in the given year with a negative gross income of another member of the group in that given year;

- (b) the institution shall not, pursuant to *paragraph (a)*, offset positive gross income with negative gross income between any of the last 3 years.

(6) Where an authorized institution which calculates its capital adequacy ratio on a consolidated basis uses the STO or ASA to calculate its operational risks then -

- (a) subject to *paragraph (b)*, the institution may, in calculating the gross income of the consolidation group in any given year of the last 3 years, offset a positive gross income of a standardized business line of a member of the group in the given year with a negative gross income of that standardized business line of another member of the group in that given year;
- (b) the institution shall not, pursuant to *paragraph (a)*, offset positive gross income with negative gross income between any of the last 3 years.

(7) Subject to *subsection (8)*, an authorized institution which calculates its capital adequacy ratio on a consolidated basis shall do so using the same approach in calculating a relevant risk as it would be required to use if it were calculating that ratio on an unconsolidated basis.

(8) An authorized institution is not required to comply with *subsection (7)* in respect of such members of the consolidation group as the Monetary Authority permits in a prior consent given by the Monetary Authority to the institution.

[14. Provision not used]

15. Exceptions to *section 10*

- (1) Where -
- (a) an authorized institution calculates its capital adequacy ratio on a consolidated basis; and
 - (b) an eligible subsidiary of the institution incorporated in a country other than Hong Kong calculates its capital adequacy ratio on a solo basis in accordance with the capital adequacy standards applicable in that country,

then the institution may make an application to the Monetary Authority for approval to risk-weight the eligible subsidiary's exposures in accordance with those standards instead of in accordance with these Rules.

- (2) Subject to *subsection (3)*, the Monetary Authority shall determine an application under *subsection (1)* from an authorized institution by -
- (a) granting approval to the institution to risk-weight the exposures of the eligible subsidiary specified in the application in accordance with the capital adequacy standards applicable in the country where the eligible subsidiary is incorporated instead of in accordance with these Rules and giving the institution a section 98(2) requirement to give effect to such approval; or
 - (b) refusing to grant such approval.

(3) Without limiting the generality of *subsection (2)(b)*, the Monetary Authority shall refuse to grant approval to an authorized institution to risk-weight the exposures of an eligible subsidiary of the institution in accordance with the capital adequacy standards applicable in the country in which the eligible subsidiary is incorporated instead of in accordance with these Rules unless the institution satisfies the Monetary Authority that the use of those standards would not cause a significant impact on the institution's capital adequacy ratio.

(4) An authorized institution which calculates its capital adequacy ratio on a consolidated basis may make an application to the Monetary Authority for approval to calculate that ratio by excluding one or more than one member from the consolidation group.

(5) Subject to *subsection (6)*, the Monetary Authority shall determine an application under *subsection (4)* from an authorized institution by -

- (a) granting approval to the institution to calculate its capital adequacy ratio by excluding from the consolidation group such members of the group as the Monetary Authority specifies and giving the institution a section 98(2) requirement to give effect to such approval; or
- (b) refusing to grant such approval.

(6) Without limiting the generality of *subsection(5)(b)*, the Monetary Authority shall refuse to grant approval to an authorized institution to calculate its capital

adequacy ratio by excluding from the consolidation group any member of the group unless the institution satisfies the Monetary Authority that the inclusion of that member in the group -

- (a) would be inappropriate or misleading; or
- (b) is not practicable due to regulatory, legal or taxation constraints on the transfer of information necessary to enable the institution to calculate that ratio on a consolidated basis in respect of that member.

PART 3

DETERMINATION OF CAPITAL BASE

16. Determination of capital base

(1) Subject to *subsection (2)* and to *sections 22* and *23*, an authorized institution shall determine its capital base by adding together the institution's total core capital and total supplementary capital.

(2) The total supplementary capital of an authorized institution, before making any deductions therefrom required by *section 23(2)*, which may be included in the determination of the institution's capital base shall not exceed the institution's total core capital -

- (a) after making the deductions therefrom required by *section 23(1)*;
but
- (b) before making the deductions therefrom required by *section 23(2)*.

17. Core capital of authorized institution

(1) Subject to *sections 18A(5), 18B(2), 19(3)(a), 22 and 23*, the core capital of an authorized institution shall consist of -

- (a) the institution's paid-up ordinary share capital except any shares issued by the institution by virtue of capitalising any property revaluation reserves of the institution referred to in *section 18(1)(a)*;
- (b) the institution's paid-up irredeemable non-cumulative preference shares;
- (c) the amount standing to the credit of the institution's share premium account;
- (d) subject to *section 17B*, the institution's published reserves except -
 - (i) unrealized fair value gains and losses on revaluation of loans designated as available-for-sale;
 - (ii) cumulative fair value gains or losses on the hedged items and the hedging instrument in respect of cash flow hedges created for -
 - (A) available-for-sale financial instruments; and
 - (B) financial instruments measured at amortised cost;
 - (iii) cumulative fair value gains or losses on the hedging instrument that are recognized directly in equity through the statement of changes in equity in respect of cash flow hedges created for forecast transactions; and

- (iv) any published reserves falling within *paragraph (e)* or *section 18*;
- (e) subject to *section 17C*, the institution's unaudited profit or loss of the current financial year, and the institution's profit or loss of the immediately preceding financial year pending audit completion, except -
 - (i) any unrealised fair value gains or losses on financial liabilities arising from any change in the institution's credit worthiness; and
 - (ii) any profit or loss referred to in *section 18*; and
- (f) subject to *section 17D*, minority interests in the equity of the institution's subsidiaries arising from a consolidation requirement except any such minority interests that are not freely transferable to -
 - (i) the institution; or
 - (ii) members of the group of companies of which the institution is a member,after taking into account any relevant regulatory, legal or taxation constraints on the transfer of capital.

(2) In *subsection (1)(e)(i)*, "fair value gains or losses" (), in relation to an authorized institution, means the institution's fair value gains or losses gross of any deferred tax provisions attributable to the fair value gains or losses.

[17A. Provision not used.]

17B. Provisions supplementary to *section 17(d)*

An authorized institution's published reserves falling within *section 17(d)* as at a particular date shall be net of dividends -

- (a) proposed or declared by the institution after that date; and
- (b) that, as at that date, are recorded, or are required to be recorded, as equity on the institution's balance sheet.

17C. Provisions supplementary to *section 17(e)*

(1) An authorized institution's profit or loss falling within *section 17(e)* as at a particular date shall be net of dividends -

- (a) proposed or declared by the institution after that date; and
- (b) that, as at that date, are recorded, or are required to be recorded, as equity on the institution's balance sheet.

(2) An authorized institution may, with the prior consent of the Monetary Authority, include in its profit or loss falling within *section 17(e)* any unrealised fair value gains arising from the institution's holding of equities and debt securities designated at fair value through profit or loss in its profit or loss account.

17D. Provisions supplementary to *section 17(f)*

(1) An authorized institution's core capital consisting of minority interests falling within *section 17(f)* that arise on consolidation in the paid-up irredeemable non-cumulative preference shares of the institution's subsidiaries which are SPVs shall not constitute more than 15% of the institution's total core capital (including minority interests falling within that section) after making the deductions therefrom required by *section 23(1)* but before making the deductions therefrom required by *section 23(2)*.

(2) An authorized institution's core capital consisting of minority interests falling within *section 17(f)* as at a particular date shall be net of dividends -

- (a) proposed or declared by the institution's subsidiaries after that date;
and
- (b) that, as at that date, are recorded, or are required to be recorded, as equity on the subsidiaries' balance sheets.

18. Supplementary capital of authorized institution

(1) Subject to *sections 22 and 23*, the supplementary capital of an authorized institution shall consist of -

- (a) subject to *section 18A*, that part ("1st relevant part") of the institution's reserves that is attributable to fair value gains in profit or loss on -
 - (i) the revaluation of the institution's holdings of land and buildings except land and buildings mortgaged to the institution to secure a debt; and
 - (ii) the revaluation of the institution's share of the net asset value of any subsidiary of the institution to the extent that the value has changed as a result of the revaluation of the subsidiary's holdings of land and buildings except land and buildings mortgaged to the subsidiary to secure a debt;
- (b) subject to *section 18B*, that part ("2nd relevant part") of the institution's reserves that is attributable to fair value gains -
 - (i) on the revaluation of the institution's holdings of equities and debt securities not held for trading purposes; and
 - (ii) arising from the institution's holdings of equities and debt securities designated at fair value through profit or loss which do not fall within *section 17(e)*;
- (ba) with the prior consent of the Monetary Authority, that part of the institution's reserves that is attributable to fair value gains on the

institution's holdings of any other financial assets not held for trading purposes, including such assets that are available-for-sale or designated at fair value through profit or loss;

- (c) subject to *section 19*, the institution's regulatory reserves for general banking risks and collective provisions;
- (d) the institution's perpetual subordinated debt where, under the terms on which the debt instrument is to be issued, the Monetary Authority is satisfied that the following conditions are met (and, after issue, is satisfied that the following conditions continue to be met) -
 - (i) the claims of the lender against the institution are fully subordinated to those of all unsubordinated creditors;
 - (ii) the debt is not secured against any assets of the institution;
 - (iii) the money advanced to the institution is permanently available to it;
 - (iv) the debt is not repayable without the prior consent of the Monetary Authority;
 - (v) the money advanced to the institution is available to meet losses without the institution being obliged to cease trading;
 - (vi) the institution is entitled to defer the payment of interest where its profitability will not support such payment; and

- (vii) if the rate of interest payable on the debt is liable to be increased under the terms of the debt instrument, the rate of interest will not be increased -
 - (A) until the expiry of 10 years from the day when the debt is issued;
 - (B) more than once; and
 - (C) beyond a limit considered appropriate by the Monetary Authority;

- (e) the institution's paid-up irredeemable cumulative preference shares where, under the terms on which the shares are to be issued, the Monetary Authority is satisfied that the following conditions are met (and, after issue, is satisfied that the following conditions continue to be met) -
 - (i) the shares are not redeemable without the prior consent of the Monetary Authority;
 - (ii) the money raised by the issue of the shares is available to meet losses without the institution being obliged to cease trading; and
 - (iii) if the dividends payable on the shares are liable to be increased under the terms, such dividends will not be increased -
 - (A) until the expiry of 10 years from the day when the shares are issued;

- (B) more than once; and
 - (C) beyond a limit considered appropriate by the Monetary Authority;
- (f) subject to *section 20*, the institution's term subordinated debt where, under the terms on which the debt instrument is to be issued, the Monetary Authority is satisfied that the following conditions are met (and, after issue, is satisfied that the following conditions continue to be met) -
- (i) the claims of the lender against the institution are fully subordinated to those of all unsubordinated creditors;
 - (ii) the debt is not secured against any assets of the institution;
 - (iii) the debt has a minimum initial period to maturity of more than 5 years (even though that period may be subsequently reduced with the prior consent of the Monetary Authority);
 - (iv) any debt repayable prior to maturity will not be so repaid without the prior consent of the Monetary Authority; and
 - (v) if the rate of interest payable on the debt is liable to be increased under the terms of the debt instrument, the rate of interest will not be increased -
 - (A) until the expiry of 5 years from the day when the debt is issued;
 - (B) more than once; and

- (C) beyond a limit considered appropriate by the Monetary Authority.
- (g) subject to *section 20*, the institution's paid-up term preference shares where, under the terms on which the shares are to be issued, the Monetary Authority is satisfied that the following conditions are met (and, after issue, is satisfied that the following conditions continue to be met) -
 - (i) the shares have a minimum initial period to maturity of more than 5 years (even though that period may be subsequently reduced with the prior consent of the Monetary Authority);
 - (ii) any shares redeemable prior to maturity will not be so redeemed without the prior consent of the Monetary Authority; and
 - (iii) if the dividends payable on the shares are liable to be increased under the terms, such dividends will not be increased -
 - (A) until the expiry of 5 years from the day when the shares are issued;
 - (B) more than once; and
 - (C) beyond a limit considered appropriate by the Monetary Authority; and
- (h) subject to *section 21*, minority interests -

- (i) in the paid-up irredeemable cumulative preference shares and paid-up term preference shares of the institution's subsidiaries arising from a consolidation requirement imposed on the institution; and
- (ii) that are not included in the institution's core capital pursuant to *section 17(f)*.

(2) In *subsection (1)(a)* and *(b)* -
"reserves" (), in relation to an authorized institution -

- (a) means the institution's reserves gross of any deferred tax provisions attributable to the reserves;
- (b) includes, in relation to *subsection (1)(a)*, shares issued by the institution through capitalizing reserves falling within the 1st relevant part of the institution's reserves.

18A. Provisions supplementary to section 18(1)(a)

(1) The 1st relevant part of an authorized institution's reserves shall not fall within section 18(1)(a) -

- (a) unless -
 - (i) the institution has an established policy on the frequency and method of revaluation of its holdings of land and buildings which is satisfactory to the Monetary Authority;
 - (ii) the institution does not depart from that policy except after consultation with the Monetary Authority;
 - (iii) subject to *subparagraph (iv)*, any revaluation of the institution's holdings of land and buildings is undertaken by an independent professional valuer;
 - (iv) in any case where the institution satisfies the Monetary Authority that, despite all reasonable efforts, it has been unable to obtain the services of an independent professional valuer to undertake the revaluation of all or part, as the case may be, of the institution's holdings of land and buildings, any revaluation of such holdings undertaken by a person who is not an independent professional valuer is endorsed in writing by an independent professional valuer;
 - (v) any revaluation of the institution's holdings of land and buildings is -
 - (A) approved by the institution's external auditors; and

(B) explicitly reported in the institution's audited accounts; and

(b) unless the fair value gains referred to in *section 18(1)(a)* are recognized in accordance with relevant accounting standards and any such gains not recognized on the balance sheet of the institution are excluded from the 1st relevant part.

(2) Subject to *subsections (3) and (3A)*, an authorized institution shall not include in its supplementary capital more than 45% of any fair value gains of any item referred to in *section 18(1)(a)* arising from any revaluation referred to in that section.

(3) Subject to *subsection (3A)*, an authorized institution shall only include in its supplementary capital -

(a) that amount of fair value gains referred to in *section 18(1)(a)* which arise from revaluations referred to in *section 18(1)(a)(i)* as does not exceed the amount that was included in the institution's supplementary capital as at -

(i) 31 December 1998 in respect of the like gains as at that date if the institution was an authorized institution on that date; or

(ii) in any other case, the relevant date in respect of the like gains as at that date; and

(b) that amount of fair value gains referred to in *section 18(1)(a)* which arise from revaluations referred to in *section 18(1)(a)(ii)* as

does not exceed the amount that was included in the institution's supplementary capital as at -

- (i) 31 December 1998 in respect of the like gains as at that date if the institution was an authorized institution on that date;
- (ii) in any other case, the relevant date in respect of the like gains as at that date.

(3A) An authorized institution shall not include any fair value gains referred to in *section 18(1)(a)* for the purposes of determining its capital base unless -

- (a) the gains comprise any amount of fair value gains that as at -
 - (i) 31 December 1998 were reported to the Monetary Authority if the institution was an authorized institution on that date; or
 - (ii) in any other case, the relevant date were reported to the Monetary Authority; or
- (b) the gains arise from a merger or acquisition and the institution has the prior consent of the Monetary Authority to so use the gains.

(4) An authorized institution shall not, in calculating its supplementary capital, set-off losses in respect of land and buildings which are for the institution's own use where the losses are recognized in the institution's profit or loss against unrealised gains that are reflected directly in equity through the statement of changes in equity.

(5) An authorized institution shall deduct from its core capital any cumulative losses of the institution arising from the institution's holdings of land and buildings below

the depreciated cost value (whether or not any such land and buildings are held for the institution's own use or for investment purposes).

(6) In *subsections (3) and (3A)* -

"relevant date" (), in relation to an authorized institution, means that date after 31 December 1998 on which the institution became an authorized institution;

"supplementary capital" (), has the meaning assigned to it by the Third Schedule to the Ordinance as in force on 31 December 1998.

18B. Provisions supplementary to section 18(1)(b)

- (1) An authorized institution shall not include in its supplementary capital more than 45% of any fair value gains -
 - (a) referred to in *section 18(1)(b)(i)* arising from any revaluation referred to in that section; and
 - (b) referred to in *section 18(1)(b)(ii)*.
- (2) An authorized institution -
 - (a) shall deduct from its core capital -
 - (i) cumulative unrealised losses of the institution -
 - (A) arising from securities held by the institution for purposes other than trading purposes; and
 - (b) which fall below the cost of those securities; and
 - (ii) impairment losses in respect of securities held by the institution for purposes other than trading purposes; and
 - (b) shall not, for the purposes of *paragraph (a)(ii)*, set-off any impairment losses in respect of securities referred to in that paragraph against any unrealised gains in respect of those securities.
- (3) An authorized institution shall deduct from its supplementary capital an overall deficit arising from the revaluation of its holdings of equities and debt securities falling within *section 18(1)(b)* (but excluding any losses falling within *subsection (2)(a)*).
- (4) An authorized institution shall exclude from its supplementary capital any unrealised gains and losses on loans designated as available-for-sale.

19. Provisions supplementary to section 18(1)(c)

(1) Subject to *subsections (2) and (3)*, an authorized institution which uses the BSA or STC, or both, to calculate its credit risk shall not include in its supplementary capital that amount of its reserves for general banking risks and collective provisions which exceeds 1.25% of the institution's total risk-weighted assets and risk-weighted exposures (being the sum of all the institution's risk-weighted assets and risk-weighted exposures for all the institution's exposures to credit risk subject to the BSA or STC, or both, operational risk and market risk).

(2) An authorized institution which uses any combination of the BSA, STC or IRB to calculate its credit risk -

- (a) subject to *paragraph (b)*, shall apportion its total regulatory reserves for general banking risks and collective provisions between the BSA, STC or IRB on a pro rata basis according to the proportions of the institution's risk-weighted assets and risk-weighted exposures to credit risk which are calculated using the BSA, STC or IRB, as the case requires;
- (b) may, with the prior consent of the Monetary Authority, use its own method for apportioning its total regulatory reserves for general banking risks and collective provisions for recognition as supplementary capital under the BSA or STC, or both, and that is subject to the IRB for the calculation of the institution's credit risk;
- (c) shall, after it has carried out the apportionment referred to in *paragraph (a) or (b)* -

- (i) comply with *subsection (1)* in respect of that portion of its total regulatory reserves for general banking risks and collective provisions which is subject to the BSA or STC, or both, for the calculation of the institution's credit risk; and
 - (ii) exclude from its supplementary capital that portion of its total regulatory reserves for general banking risks and collective provisions which is subject to the IRB for the calculation of the institution's credit risk.
- (3) Where an authorized institution uses the IRB to calculate its credit risk -
 - (a) subject to *subsection (2)(c)(ii), paragraph (b) and section 23(2)(ab)*, the institution shall adjust its core capital or supplementary capital by reference to the difference between the institution's total EP and total EL amount in respect of sovereign, bank, corporate and retail exposures of the institution that are subject to the IRB;
 - (b) if the total EL amount referred to in *paragraph (a)* is less than the total EP referred to in that paragraph, the institution may include the excess of all the total EP over the total EL amount in its supplementary capital up to a maximum of 0.6% of its total risk-weighted assets and risk-weighted exposures subject to the IRB [but not subject to *Part 7*].

20. Provision supplementary to *section 18(1)(f)* and *(g)*

An authorized institution shall -

- (a) in the case of a debt instrument falling within *section 18(1)(f)* or a share falling within *section 18(1)(g)*, for the purposes of calculating its supplementary capital, discount by 20% the original amount of the debt instrument or share, as the case may be, each year during the 4 years immediately preceding the maturity of the debt instrument or share, as the case may be; and
- (b) exclude from its supplementary capital any amount by which the sum of the amounts falling within *section 18(1)(f)* and *(g)* exceeds 50% of the total of the institution's core capital -
 - (i) after making the deductions therefrom required by *section 23(1)*; but
 - (ii) before making the deductions therefrom required by *section 23(2)*.

21. Provisions supplementary to *section 18(1)(h)*

An authorized institution's minority interests falling within *section 18(1)(h)* as at a particular date shall be net of dividends -

- (a) proposed or declared by the institution's subsidiaries after that date;
and
- (b) that, as at that date, are recorded, or are required to be recorded, as equity on the subsidiaries' balance sheets.

22. Essential characteristics of core and supplementary capital

(1) An authorized institution shall not include any capital in its core capital unless the capital -

- (a) is subordinated;
- (b) is perpetual; and
- (c) is non-cumulative.

(2) An authorized institution shall not include any capital in its core or supplementary capital unless the capital -

- (a) is freely available to absorb the institution's losses;
- (b) ranks behind the claims of depositors and other creditors of the institution in a winding-up of the institution;
- (c) in the case of capital taking the form of shares or debt instruments -
 - (i) the shares permit, without restrictions, the non-payment of a dividend; and
 - (ii) the debt instruments are subject to a contractual right to defer interest payments; and
- (d) is unsecured and fully paid-up.

(3) For the avoidance of doubt, it is hereby declared that guarantees and other types of contingent liability shall not be included in an authorized institution's core or supplementary capital.

(4) An authorized institution shall not issue any capital instrument other than ordinary shares (including issue by way of a subsidiary or SPV of the institution) unless it

has consulted with the Monetary Authority to ascertain whether, under these Rules, the instrument proposed to be issued -

- (a) can be included in the institution's core capital;
- (b) can be included in the institution's supplementary capital; or
- (c) cannot be included in the institution's core or supplementary capital.

(5) An authorized institution shall not include, in its core or supplementary capital, a capital instrument issued at a discount, or only partly in a paid-up form, except to the extent that the proceeds paid-up on the instrument have been received by, and are immediately available to, the issuer of the instrument.

23. Deductions from core and supplementary capital

- (1) An authorized institution shall deduct from its core capital -
 - (a) the amount of goodwill reported as at the reporting calendar quarter end date of the institution, including -
 - (i) any goodwill relating to the institution's holdings in shares and other regulatory capital instruments which are subject to any deduction required by *subsection (2)*; and
 - (ii) any goodwill relating to the subsidiaries of the institution;
 - (b) other intangible assets of the institution reported as at the reporting calendar quarter end date of the institution;
 - (c) the amount of net deferred tax assets of the institution reported as at the reporting calendar quarter end date of the institution; and
 - (d) the amount of any gain-on-sale arising from a securitization transaction in respect of securitization exposures that are subject to deduction under the [securitization framework].

- (2) Subject to *section 23A(1)*, an authorized institution shall deduct from its core and supplementary capital -
 - (a) subject to *subsection (1)(a)(i)*, the amount of the institution's holding of shares in a holding company of the institution;
 - (ab) if the institution uses the IRB to calculate its credit risk and the institution's total EL amount referred to in *section 19(3)(a)* exceeds the institution's total EP referred to in that section, the excess of the total EL amount over the total EP;

- (b) subject to *subsection (1)(a)(i)*, the amount of the institution's holdings of shares and other regulatory capital instruments issued by a company in which the institution is entitled to exercise, or control the exercise of, more than 20% of the voting power at any general meeting of the company (and whether or not the company is a subsidiary of the institution) but excluding -
 - (i) any such shares and other regulatory capital instruments held by the institution in a subsidiary of the institution the subject of a consolidation requirement; or
 - (ii) the institution's reserves -
 - (A) arising from the revaluation of the holdings of land and buildings of a subsidiary of the institution; and
 - (B) not falling within the definition of "reserves" in *section 18(2)*;
- (ba) subject to *subsection (1)(a)(i)*, the amount of the institution's holdings in shares and other regulatory capital instruments in any relevant subsidiary undertaking of the institution excluding any such holdings -
 - (i) falling within *paragraph (b)*; or
 - (ii) excluded from *paragraph (b)* by virtue of falling within *subparagraph (i) or (ii) of paragraph (b)*;
- (c) subject to *subsection (1)(a)(i)*, the amount of the institution's holding of shares and other regulatory capital instruments issued

by any bank not falling within *paragraph (a), (b) or (ba)* except where the institution satisfies the Monetary Authority that the holding -

- (i) is not the subject of an arrangement whereby 2 or more persons agree to hold each other's capital; or
 - (ii) is not otherwise a strategic investment;
- (d) subject to *subsection (1)(a)(i)*, the amount of the institution's -
- (i) loans to;
 - (ii) holding of shares and debentures issued by; and
 - (iii) guarantees of the liabilities of,
- a connected company of the institution, not falling within *paragraph (a), (b), (ba) or (c)*, unless the institution satisfies the Monetary Authority that the loan was made, the shares and debentures are being held, or the guarantee was given, as the case may be, in the ordinary course of the institution's business;
- (e) subject to *subsection (1)(a)(i)*, in the case of the institution's holding of shares in any company not falling within *paragraph (a), (b), (ba), (c) or (d)*, where the book value of the holding exceeds 15% of the capital base of the institution as reported in the institution's last quarter end's capital adequacy ratio return, that amount of the book value of the holding which exceeds that 15%;

- (f) subject to *subsection (2A)* and *section 23A(3)*, the amount of any relevant capital shortfall in respect of a subsidiary of the institution -
 - (i) which is a securities firm or insurance firm; and
 - (ii) which is not the subject of a consolidation requirement imposed on the institution;
- (g) if the institution uses the PD/LGD approach to calculate its credit risk in respect of equity exposures, the EL amount of such exposures subject to the corresponding conditions set out in *Part 4* relating to the use of the IRB to calculate credit risk; and
- [(h) the amount[, specified as the relevant amount,] of the items listed in *Schedule 5*.]

(2A) Where a subsidiary of an authorized institution which is a securities firm or insurance firm fails to meet the regulatory capital requirements applicable to it, then -

- (a) the institution shall, as soon as is practicable after it becomes aware of the failure, give notice in writing to the Monetary Authority of particulars of the securities firm or insurance firm, as the case may be, and the details of the failure; and
- (b) the Monetary Authority may, by notice in writing given to the institution, and beginning on such date, or the occurrence of such event, as is specified in the notice, and ending on such date, or the occurrence of such event, as is specified in the notice, require the institution to deduct from the calculation of its capital base an

amount which, in the opinion of the Monetary Authority, represents the shortfall of the securities firm or insurance firm, as the case may be, in meeting those capital adequacy requirements.

(3A) For the avoidance of doubt, it is hereby declared that -

- (a) *subparagraph (i) of paragraph (b) of subsection (2)* does not apply only when an authorized institution is calculating its capital adequacy ratio on a solo basis;
- (b) in the case of an authorized institution calculating its capital adequacy ratio on a solo-consolidated basis, the reference to "subsidiary" in *subparagraph (i) of paragraph (b) of subsection (2)* means a solo-consolidated subsidiary of the institution.

(4) In this section -

"relevant capital shortfall" (), in relation to a subsidiary of an authorized institution, means the amount specified in a notice under *subsection (2A)* given to the institution in respect of that subsidiary;

"relevant subsidiary undertaking" (), in relation to an authorized institution, means a subsidiary undertaking of the institution which is not a member of the consolidation group but does fall within the range of consolidation specified in accounting standards issued by the Hong Kong Institute of Certified Public Accountants pursuant to section 18A of the Professional Accountants Ordinance (Cap. 50).

23A. Provisions supplementary to *section 23(2)*

- (1) An authorized institution shall -
 - (a) subject to *paragraph (c)* and *subsection (3)*, deduct from its core capital 50% of any specified amount;
 - (b) subject to *paragraph (c)* and *subsection (3)*, deduct from its supplementary capital 50% of any specified amount; and
 - (c) deduct from its core capital such amount of any specified amount which cannot be deducted under *paragraph (b)* because it exceeds the amount of supplementary capital available for such deduction under that paragraph.

[(2) Provision not used.]

- (3) It is hereby declared that the amount to be deducted under *section 23(2)(f)*

by an authorized institution from its core and supplementary capital -

- (a) is in addition to any other deduction the institution is required to make under *section 23(2)* from its core and supplementary capital in respect of the subsidiary concerned of the institution; and
- (b) represents the amount by which that subsidiary is deficient in meeting its minimum capital requirements.

[24. Provision not used.]

SCHEDULE 5

[s. 23(2)(h)]

**OTHER DEDUCTIBLE ITEMS UNDER RISK-WEIGHTING FRAMEWORK FOR CREDIT RISK
AND ASSET SECURITISATION FRAMEWORK**

[This Schedule is temporarily vacant]

Explanatory Note

Part 2 - Application of these Rules

Division 2 - Prescribed calculation approaches

1. *Section 3* specifies that an authorized institution must use the standardized approach ("STC") to calculate its credit risk (see *Part 4*) unless it has the approval of the MA to use the basic approach ("BSA") to calculate its credit risk (see *Part 4*) or the internal ratings-based approach ("IRB") to calculate its credit risk (see *Part 4*). *Section 4* specifies that the MA shall refuse to grant approval to an authorized institution to use the BSA or IRB to calculate its credit risk if any of the criteria specified in *section 5* (in the case of the BSA) or *section 6* (in the case of the IRB) are not fulfilled with respect to the institution.
2. *Section 7* provides that the use by an authorized institution of the BSA to calculate its credit risk on the ground specified in *section 5(b)* is for a transitional period only (see the definition of "transitional period" in *section 2(1)*), as it is intended that such an institution shall eventually use only the STC or IRB, or a combination of the two, to calculate credit risk. *Section 8* provides, inter alia, that an authorized institution shall not use more than one approach (that is, the STC, BSA or IRB) to calculate its credit risk in respect of all its exposures falling within one class of exposures of the institution.

3. *Section 9* specifies the action that may be taken by the MA if an authorized institution which uses the BSA or IRB to calculate its credit risk can no longer fulfil the criteria specified in *section 5* or *6*, as the case may be. Two of the more important actions that may be taken by the MA are to require such an authorized institution to use the STC instead of the BSA or IRB to calculate its credit risk in respect of all or parts of the business as specified by the MA and, in the case of such an authorized institution using the IRB to calculate its credit risk, to require the institution to adopt measures which, in the opinion of the MA, will cause the institution to again fulfil the criteria specified in *section 6* or will cause the effect of not fulfilling such criteria to be mitigated.

Division 4 - Solo, solo-consolidated and consolidated bases for calculation of capital adequacy ratio

- 3A. *Section 10* requires an authorized institution to use both the solo basis and the consolidated basis to calculate its and its consolidation group's capital adequacy ratio. However, an authorized institution may use the solo-consolidated basis instead of the solo basis to calculate its capital adequacy ratio if it has approval to do so under *section 12(2)(a)*. It should be noted that the solo basis for the calculation of an authorized institution's capital adequacy excludes any subsidiaries of the institution from the calculation. The consolidated basis for the calculation includes the authorized institution's subsidiaries specified by the Monetary Authority in a section 98(2) requirement. The solo-consolidated basis

- for the calculation of an authorized institution's capital adequacy ratio permits, in effect, certain specialized subsidiaries within the institution's consolidation group to be included in calculating the institution's solo risk-weighted exposures. The definitions of "consolidated basis", "consolidation group", "consolidation requirement", "section 98(2) requirement", "section 79A(1) requirement", "solo basis", "solo-consolidated basis", "solo-consolidated subsidiary" and "subsidiary undertaking" are all relevant to understanding the provisions of *Division 4*.
- 3B. *Section 11* states what an authorized institution shall do in calculating its capital adequacy ratio on a solo basis. *Section 12* specifies that an authorized institution may make an application to the Monetary Authority for approval to calculate its capital adequacy ratio on a solo-consolidated basis instead of a solo basis, specifies the grounds on which the Monetary Authority grants or refuses such approval and states what the institution shall do, if it is granted such approval, in calculating its capital adequacy ratio on a solo-consolidated basis.
- 3C. *Section 13* states what an authorized institution shall do in calculating its capital adequacy ratio on a consolidated basis. *Section 13A* contains provisions supplementary to *section 13*.
- 3D. *Section 15* permits, subject to the approval of the Monetary Authority, certain exceptions to the requirement in *section 10(1)* that an authorized institution calculate its capital adequacy ratio on a consolidated basis. The exceptions relate to approving the institution risk-weighting the exposures of an eligible subsidiary of the institution in accordance with the capital adequacy standards applicable to

the country in which the subsidiary is incorporated, or to excluding certain subsidiaries from the institution's consolidation group.

Part 3 - Determination of Capital Base

4. *Part 3* specifies how an authorized institution determines its capital base. In this respect, the definition of "capital base" in section 2(1) of the Ordinance, as read with the reference to "capital base" in the definition of "capital adequacy ratio" in that section, should be noted.
5. *Section 16(1)* specifies that an authorized institution's capital base is determined by adding together its total core capital and total supplementary capital subject to the restrictions specified in *section 16(1)* and (2). However, an authorized institution is not permitted to include any capital in its core or supplementary capital unless the capital meets the essential characteristics applicable to core or supplementary capital specified in *section 22*. Furthermore, *sections 23* and *23A* and *Schedule 5* specify the deductions that an authorized institution shall make from its core and supplementary capital.
6. *Section 17* specifies the capital that constitutes the core capital of an authorized institution. However, the qualifications and restriction specified in *sections 17B, 17C, 17D, 18A(5), 18B(2)* and *19(3)(a)* on various types of capital should be noted. *Section 18* specifies the capital that constitutes the supplementary capital of an authorized institution. However, the qualifications and restrictions specified in *sections 18A, 18B, 19, 20* and *21* on various types of capital should be noted.