PROPOSED AMENDMENTS TO BANKING (CAPITAL) RULES ("BCR") ARISING FROM IMPLEMENTATION ISSUES

A. Part 1 of BCR

BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
1. §2(1) Interpretation	The definition of "delivery-versus-payment basis" is intended to cover payment-versus-payment transactions, but the drafting of the definition has not made such policy intent explicit.	The term "delivery-versus-payment basis" will be amended to make it clear that payment-versus-payment transactions are included.

B. Part 2 of BCR on prescribed approaches to calculation of credit risk

BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
1. §§33(1), (2) and (3) Approaches used by AIs' subsidiaries when calculating capital adequacy ratio on consolidated basis	Under §32(1), an authorized institution (AI) and its subsidiaries should use the same approach to calculating a relevant risk (i.e. credit, market and operational risks) when calculating the AI's consolidated capital adequacy ratio. However, §33(1) allows the AI to apply to the Monetary Authority ("MA") for a permission to deviate from §32(1) by risk-weighting the exposures held by a subsidiary incorporated in a country other than Hong Kong using the capital adequacy standards of that country. While the scope of the exemption as permitted under §33(1) should cover all exposures held by the subsidiary, AIs may want to apply for exemptions, or the MA will only be prepared to approve such applications, for certain classes of exposures only.	§33 will be modified such that an AI may apply to the MA for a permission to risk-weight a specified category of exposures held by the AI's subsidiary incorporated in a country other than Hong Kong in accordance with the capital adequacy standards applicable in that country. The proposed amendment will allow more flexibility for the MA to deal with practical issues faced by AIs.

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C. Part 3 of BCR on determination of capital base

BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
1. §37(3) Essential characteristics of core capital and supplementary capital	Our policy intention has not been clearly reflected in the existing text: "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 capital and supplementary capital."	In order to improve clarity, the section should be revised to give the following meaning: "For the avoidance of doubt, an authorized institution's core capital or supplementary capital *shall not be secured or covered by a guarantee and other types of contingent liability of the issuer or related entity that legally or economically enhances the seniority of the claim*."

D. Part 4 of BCR on Standardized (credit risk) approach (STC approach) for credit risk

BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
1. §65(1)(e) Residential mortgage loans	A residential mortgage loan (RML) which meets all the requirements stated in §65(1) can be assigned a preferential risk-weight of 35%. The two major requirements stated in §65(1) are that (i) the LTV ratio of the loan does not exceed 70% at the time a commitment to extend the loan was made (§65(1)(d)) and (ii) the LTV ratio of the loan does not exceed 100% <u>at any time</u> after the loan is drawn by the borrower (§65(1)(e)). The latter is considered by some AIs to penalise cases where the current LTV ratio of a RML is well below	In light of the comments received, the HKMA proposes to revise §65(1)(e) to the following: • After the loan is drawn by the borrower or purchased by the institution, as the case may be, the LTV ratio of the loan does not exceed 100% at the time of the determination of the current capital adequacy ratio of the AI concerned.

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	100%, but where the loan was once a negative-equity loan. The policy intent of the 100% LTV requirement is to ensure that the preferential risk-weight of 35% will not apply to a loan which is in negative equity at the time of calculating the capital adequacy ratio subsequent to the loan drawdown. However, the drafting of §65(1)(e) has an unintended effect of extending the restriction to cover all historical ratios of LTV of the loan after its drawdown.	
2. §66(1) Other exposures which are not past due exposures	Under Basel I and the repealed Third Schedule to the Banking Ordinance ("BO"), exposures to regulatory capital instruments issued by banks or other financial institutions were required to be treated as other assets and risk-weighted at 100% unless the exposures are deducted from the capital base. The capital treatment of these exposures remains unchanged under Basel II and it remains the HKMA's policy intent that exposures to these capital instruments (whether rated or unrated) should be risk-weighted at 100%. According to this policy, exposures to regulatory capital instruments issued by banks or other financial institutions should be classified as "Other exposures which are not past due exposures" and captured under §66. However, this section should be clarified to explicitly capture these exposures for the avoidance of doubt.	§66(1) will be amended to make it clear that exposures to "other regulatory capital instruments" as defined in §35 of the BCR which are not subject to capital deduction as required under §48 should be classified as "Other exposures which are not past due exposures" instead of "Bank exposures", "Securities firm exposures" or "Corporate exposures" under §§59, 60 and 61 respectively.

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BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
3. §66(5) Other exposures which are not past due exposures	It is the policy intent that when an AI has difficulty in allocating any accrued interest to a particular obligor of its exposures (whether on-balance sheet or off-balance sheet), the AI may, with the MA's prior consent, treat the accrued interest as "other exposure which is not a past due exposure" and risk-weight the interest at 100%. However, §66(5) as currently drafted does not apply to accrued interest of off-balance sheet exposures such as interest rate swaps.	§66(5) will be modified such that the subsection will apply to both on-balance sheet and off-balance sheet exposures.
4. §68 Credit-linked notes	§68 requires AIs to allocate a risk-weight to a credit-linked note (CLN) which is the greater of the risk-weight of the issuer of the note and the risk-weight of the reference obligation of the note. This approach has the following issues: – AIs are not allowed to use the issue specific ratings of CLNs assigned by ECAIs for risk-weighting purposes, which is inconsistent with the treatments for other rated securities including securitization exposures. – It does not deal with the capital treatment of CLNs which link to a basket of reference entities (e.g. first-to-default CLNs). The section should therefore be modified to address the above issues.	§68 will be amended to the effect that: (a) subject to (b) below, if a CLN has an ECAI issue specific rating, the institution should determine the risk-weight of the CLN according to §§55 to 61, 66 and 67 as if it was a straight bond. (b) if a CLN has an ECAI issue specific rating and it is a first-to-default, second-to-default or nth-to-default CLN, the risk-weight of the CLN should be determined according to §74(3)(a), (4)(a) or (5) as the case requires. (c) subject to (d) below, if a CLN does not have an ECAI issue specific rating, the existing method set out in §68 will apply. (d) if a CLN does not have an ECAI issue specific rating and it is a first-to-default, second-to-default or nth-to-default CLN, the existing method set out in §68 will apply but the

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		risk-weight mentioned in §68(a) should be determined according to §74(3)(b), (4)(b) or (5) as the case requires.
5. §69(9)(a) Application of ECAI ratings	Both the BCBS's Basel II framework and the capital rules of other jurisdictions such as the UK do not explicitly disallow the use of foreign currency issuer ratings for risk-weighting exposures denominated in local currency. However, §69(9)(a) of the BCR imposes a stringent provision in that the use of foreign currency ratings (both issue-specific and issuer ratings) on local currency exposures is prohibited. The key difference between foreign currency issuer ratings and local currency issuer ratings is that the former will take into account transfer and convertibility risks which are not applicable to local currency exposures. As a foreign currency issuer rating will not be better than a local currency issuer rating, the HKMA considers it acceptable to use foreign currency issuer ratings on local currency exposures.	§69(9)(a) will be revised such that • for ECAI issue-specific ratings, the current restrictions stated in the section will continue to apply; • for ECAI issuer ratings, only the use of local currency issuer ratings on exposures denominated in foreign currencies is prohibited, but not the vice versa.
6. §84, §85 Calculation of risk-weighted amount of off-balance sheet exposures	The calculation method of the risk-weighted amount of credit derivative contracts has been omitted from these sections.	• §84 will be amended to clarify that the section does not apply to credit derivative contracts. • §85 will be amended to clarify that the section applies to credit derivative contracts.

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7. §96(2)(b)(ii) Netting of repo-style transactions	Under §96, repo-style transactions with the same counterparty can be netted if the transactions are covered by a valid bilateral netting agreement. The policy intent is that for netting of repo-style transactions booked in the trading book, the collateral arrangement in these transactions should satisfy the requirements (e.g. legal certainty) set out in §77. §96(2)(b)(ii) does not reflect such intent.	§96(2)(b)(ii) will be revised to clarify that an AI will be allowed to use §96 to calculate the net credit exposure of repo-style transactions booked in the AI's trading book only if the collateral arrangement in these transactions satisfies the requirements of §77.
8. §97 Formula 10 and Table 13 Use of value-at-risk model instead of Formula 9	Under the comprehensive approach to the treatment of recognized collateral, AIs need to apply a supervisory haircut to the value of the recognized collateral to take account of price volatility. However, AIs may, with the MA's approval, use a value-at-risk (VaR) model and Formula 10 prescribed in §97, instead of supervisory haircuts, for the aforesaid purpose. The VaR model should be subject to the back-testing requirements stipulated in §97(8). §97 was drafted based on the Basel II framework issued in 2004. However, the comprehensive version of the framework issued in June 2006 has revised the requirements for the use of VaR as follows: • The requirement of adjusting the VaR output by a multiplier determined based on the number of exceptions identified in back-testing has been removed. • The rule-based back-testing requirements have been replaced by a principle-based requirement which requires a bank to conduct back-testing on representative counterparty portfolios which should be chosen based on their sensitivity to the material risk factors and	§97 will be amended to align with the current Basel II requirements.

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	correlations to which the bank is exposed. At the time of drafting the BCR, Formula 10 and the back-testing requirements were not updated to reflect the revised requirements in view of the fact that more time was needed to study the changes compared to the 2004 version of the framework and the possible implication.	

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E. Part 5 of BCR on Basic approach for credit risk

BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
1. §§109(5), (6), (10) and (11) Sovereign exposures	It is the policy intent that only guarantees which fulfil the operational requirements set out in §132 can be used to reduce the risk-weighted amounts of exposures including loans and debt securities. However, §109(5), (6), (10) and (11), which apply to debt securities only, have the unintended effect of exempting sovereign guarantees provided to debt securities from complying with §132.	§109 will be amended to bring the credit risk mitigation treatment of sovereign guarantees provided to debt securities in line with that of sovereign guarantees provided to loans.
2. §116(1), §116(5) Other exposures	Same as Part 4 items 2 and 3 above.	Same as Part 4 items 2 and 3 above, except that the reference to "§59", "§66(1)" and "§66(5)" should be read as "§113", "§116(1)" and "§116(5)" respectively.
3. §128, §129 Calculation of risk-weighted amount of off-balance sheet exposures	Same as Part 4 item 6 above.	Same as Part 4 item 6 above, except that the reference to "§84" and "§85" should be read as "§128" and "§129" respectively.

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F. Part 6 of BCR on Internal ratings-based approach ("IRB approach") for credit risk

BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
1. §139(1) Interpretation of Part 6	**<u>Definition of "financial firm"</u>** Amendment is proposed to revise paragraph (f) of the definition of "financial firm" to rationalise it with the meaning of paragraph (g) of the term.	The phrase "or for any period of time thereafter" will be deleted from paragraph (f) of the definition of "financial firm".
2. §146 Other exposures	**<u>Treatment of regulatory capital instruments</u>** The policy intent that exposures to debt regulatory capital instruments issued by banks or other financial institutions which are not subject to capital deduction should be risk-weighted at 100% will be clarified in the BCR, in line with the proposed changes under the STC approach (item 2 of Table D) and the BSC approach (item 2 of Table E).	§146 will be amended to the effect that "other regulatory capital instruments" as defined under §35 of the BCR which are not subject to capital deduction shall be classified as "other items" instead of "bank exposures" or "corporate exposures".
3. §149 Default of obligor	**<u>Default of obligor</u>** Other than the default criteria set out in §149(1), an AI owned by a foreign bank group may also be allowed to use the default criteria used by its parent bank subject to the prior consent of the MA under §149(4). Thus it will be useful to clarify that the application of §149(1) is subject to §149(4). Besides, the phrase "… as being in default and shall not apply subsection (1)(b) to the obligor" in §149(2)(a) will be revised	§149(1) will be revised to clarify that its application is subject to §149(4). The words "shall not" in the captioned phrase in §149(2)(a) will be replaced by "may, at its discretion, also".

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	to "… as being in default and may, at its discretion, also apply subsection (1)(b) to the obligor" to give an AI the flexibility to determine whether its exposures to the same obligor, other than the defaulted retail exposure in question, should also be classified as defaulted exposures in accordance with subsection (1)(b).	
4. §154 Rating coverage	**<u>Exposures to individual entities in a connected group</u>** To be in line with the Basel II requirements and the requirements of other major jurisdictions, it is proposed to add a provision regarding the rating assignment to individual entities in a connected group. After making reference to international practices, we are of the view that a detailed framework (including the criteria to be considered for assigning different ratings for obligors in a connected group) may not be appropriate to be set out in the BCR. A high-level requirement similar to the wording set out in paragraph 423 of Basel II is proposed to provide flexibility.	§154 of the BCR will be elaborated along the following lines: Each separate legal entity to which an AI is exposed should be separately rated. The AI should demonstrate to the satisfaction of the MA that its policy regarding the assignment of obligor grades to individual obligors in a connected group is prudent and reasonable, and covers at least (i) the circumstances under which the AI may or may not assign the same obligor grade to separate obligors in a connected group; and (ii) the definition of a connected group of obligors for the purposes of rating assignment.
5. §155(e) Integrity of rating process	**<u>Use of overrides</u>** §155(e)(ii) requires AIs to "monitor the nature and performance" of overrides. However, there are no specific requirements or limitations in the BCR governing the use of	Provisions will be added to §155(e) of the BCR to require that an AI should have in place an effective process for assessing regularly the reasonableness of the criteria for overrides, and ensuring that the criteria are applied prudently and consistently and

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	overrides to ensure that the overriding mechanism is not abused.	subject to approval at the appropriate level.
6. §213(c)(i) Recognized guarantees and recognized credit derivative contracts under double default framework	**Nth-to-default credit derivative contracts** Amendment is proposed to clarify one of the circumstances under which an nth-to-default credit derivative contract could be recognized under the double default framework.	It is proposed to revise §213(c)(i) along the lines that the credit protection obtained from an nth-to-default credit derivative contract will only be recognized under the double default framework if the first-to-default credit derivative contract up to the (n-1)th-to-default credit derivative contract, which are recognized credit derivative contracts, have also been entered into.
7. §214 Capital treatment of recognized guarantees and recognized credit derivative contracts	**Credit risk mitigation in cases where the protection provider and obligor concerned are subject to different credit risk approaches** The HKMA has come across cases where an AI which adopts the foundation IRB approach ("FIRB approach"), not being able to take the credit risk mitigating ("CRM") benefit of credit protection under the FIRB approach (e.g. because the guarantee concerned was offered by an obligor subject to the STC approach and thus the guarantor did not have the relevant IRB risk estimates required for CRM recognition within the FIRB framework), transferred the underlying exposure to the STC approach so as to take the CRM benefit of the guarantee. Existing provisions in the BCR indicate that the above situation is not permissible (e.g. §11(3) and §216(3)). However, to further improve the clarity of the BCR so as to prevent possible cherry-picking between calculation approaches, it is necessary to explicitly specify	A subsection will be added into §214 to set out that, for the avoidance of doubt, if a guarantee or a credit derivative contract is provided by a counterparty whose credit risk is not calculated under Part 6, an AI should not take into account any CRM effect of such guarantee or credit derivative contract in calculating the risk-weighted amount for credit risk of the IRB exposure which is covered by the guarantee or contract.

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	that recognition of the CRM benefits of a guarantee or a credit derivative contract provided by a counterparty whose credit risk is not calculated under the IRB approach is not allowed.	
8. §220(3) to (5) Calculation of expected losses and eligible provisions for corporate, sovereign, bank and retail exposures	**Calculation of expected loss ("EL") amount** Amendments are proposed to the existing drafting to clarify that it is the EL amount (instead of the EL) of specialized lending that is calculated by multiplying the risk-weighted amount of the specialized lending exposure by 8%.	§220(3) to (5) will be revised along the following lines: (3) Subject to subsection (4), where an authorized institution uses the supervisory slotting criteria approach for its specialized lending, the institution shall determine the EL amount of the specialized lending by … 8%. (4) Subject to … mapped. TABLE 22 RISK-WEIGHTS FOR DETERMINATION OF EL AMOUNT OF SPECIALIZED LENDING (5) Where an authorized … calculating the EL amount.
9. Division 13 Capital floor	**Capital floor** The current financial crisis has revealed that many banks had not built up and maintained a sufficiently large capital buffer to withstand unforeseen distressed market conditions, posing	Division 13 of Part 6 will be revised accordingly.

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	an increased threat to financial stability. Notwithstanding the BCBS's new enhancements to the Basel II capital framework, which are being implemented in Hong Kong, it is considered prudent to confer power on the MA to require an AI to be subject to the capital floor requirements in order to enhance his ability to deal with circumstances where there is a need to safeguard the interests of depositors and potential depositors of individual AIs through the imposition of measures to preserve their capital strength and financial soundness. The circumstances where the aforesaid power may be invoked include any significant issues or concerns identified within the systems or models of individual AIs subsequent to the MA's approval as well as other broader prudential concerns that affect the overall financial soundness of the AIs. For similar purposes and/or to provide flexibility to cater for the circumstances of individual AIs, it is also proposed to confer power on the MA to specify the adjustment factors (as set out in Table 23 or such higher factors the MA considers reasonable in all circumstances of the case) for, or vary the existing adjustment factors applicable to, an AI to which the requirements of the capital floor under §225 or §226 apply.	
10. Schedule 2, §1(i)(v) Minimum requirements to be	**<u>Independent validation of significant changes to internal rating systems</u>** Amendment is proposed to expand the scope of AIs' internal	Paragraph 1(i)(v) of Schedule 2 will be revised to specify that the scope of internal independent review will be expanded to cover the proposed development of the AI's rating system, or any proposed significant

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satisfied for approval under section 8 of these rules to use IRB approach	independent validation of their rating systems under paragraph 1(i)(v) of Schedule 2 of the BCR from "any proposed development of the institution's rating system" to also include any significant proposed change to any approved rating system, the adoption of which requires the prior consent of the MA under §8(4)(b).	change to the AI's existing rating system, to assess whether the rating system will function effectively as intended if the proposed development or change is implemented.
11. (New)	**<u>Treatment of credit-linked notes</u>** A new section is required to be inserted to clarify the capital treatment of credit-linked notes.	The drafting will be along the lines of the existing provisions of §68 of the BCR under the STC approach. That is, an AI which has an exposure in respect of a credit-linked note should allocate a risk-weight to the exposure which is the greater of the risk-weight attributable to the reference obligation of the note as if the AI had a direct exposure to the reference obligation, and the attributed risk-weight of the issuer of the note.

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G. Part 7 of BCR on securitization exposures

BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
1. §227 Interpretation of Part 7	The current definition of "synthetic securitization transaction" only captures those transactions where the underlying exposures are booked on the balance sheet of the originators in the transactions. Transactions involving the issuance of synthetic CDOs which are credit-linked to certain reference obligations that are not on the balance sheet of the originators will therefore be omitted.	The definition of "synthetic securitization transaction" will be revised to include transactions in respect of which the underlying exposures are not booked on the balance sheet of the originators in the transactions.
2. §245 and §257 Calculation of risk-weighted amount of investors' interest for securitization exposures of originating institution subject to early amortization provision	• According to §245 and §257, the CCF for calculating the credit equivalent amount of the investors' interest in a securitization transaction should be determined based on the ratio of the "3-month average excess spread of the transaction" to the "trapping point of excess spread of the transaction". §§(3)(f) & (g) and §§4(f) & (g) of the two sections describe the trapping point as a level of "accumulated excess spread". This is different from the general market practice which expresses the trapping point as a level of "average excess spread". • It is the policy intent that for securitization transactions which do not require excess spread to be trapped, the trapping point for determining the CCF should be deemed to be 4.5%. Hence, the trapping point calculation method described in §(3)(g) and §(4)(g) is not necessary and should be deleted to avoid any confusion or ambiguity.	• "Accumulated excess spread" referred to in §245(3)(f), §245(4)(f), §257(3)(f) and §257(4)(f). will be revised to read "average excess spread". • §245(3)(g), §245(4)(g), §257(3)(g) and §257(4)(g) will be amended to simply describe the trapping point as 4.5%.

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3. §258 Treatment of interest rate contracts and exchange rate contracts	Part 4 is currently the part to which Part 5 (BSC Approach), Part 6 (IRB Approach) and Part 7 (securitization framework) of the Rules refer for treatment of counterparty credit exposures arising from interest rate contracts or exchange rate contracts. To cater for the potential need in future to differentiate treatment of such exposures among Part 4, Part 5 and Part 6, it would be more preferable for their treatment under IRB(S) to be referred to Part 6 (IRB Approach) instead.	§258 will be amended to change the reference from "Part 4" to "Part 6".
4. §270 Use of supervisory formula	The whole of §270 relates to the treatment of a securitization position held by an AI in a given tranche of a securitization transaction under the supervisory formula method. To facilitate interpretation and application, §270(4) should be refined to specifically describe how an AI should determine the risk weight of its unrated securitization position in a given tranche instead of an unrated securitization exposure in general.	§270(4) will be refined to follow similar wording of preceding subsections and narrow down the scope of §270(4) to refer to the determination of the risk-weight of an unrated securitization position held by the AI in a given tranche, and §270(4)(b) will be adjusted accordingly.
5. §271 Capital charge factor for underlying exposures under IRB approach	For the purpose of applying the Supervisory Formula under the IRB(S), the capital charge factor K_{IRB} of the underlying exposures should be calculated based on the IRB capital requirement for the exposures on a "gross amount" basis (i.e. including the EL portion). §271(a) should be refined to clarify this.	§271(a) will be refined to ensure that the EL portion is included in the underlying exposures for the purpose of calculating the K_{IRB} of the exposures.
6. Division 5 Specific	When an AI using the IRB(S) has made specific provision for securitization exposures, the current BCR do not provide for	Relevant sections of the BCR will be amended to provide for adjustment to be made to the risk-weighted

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risk-weighting requirements under ratings-based method Division 6 Specific risk-weighting requirements under supervisory formula method	the risk-weighted amount of such exposures to be adjusted for the specific provision made in case of (i) off-balance sheet securitization exposures under the ratings-based method and (ii) on-balance sheet securitization exposures under the supervisory formula method.	amount of securitization exposures calculated under the IRB(S) to take account of any specific provision made against the exposures.

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H. Part 8 of BCR on market risk

BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
1. §18 Authorized institution may apply for approval to use IMM approach to calculate its market risk	**<u>Approval by risk categories</u>** Currently, approval for the use of the internal models approach ("IMM approach") can only be granted by risk categories, or by local or overseas business of an AI. To provide an incentive for AIs to adopt the IMM approach, it is proposed to confer power on the MA to exclude certain positions in a risk category, or certain parts of the local or overseas business of AIs, from using the IMM approach subject to compliance with specified conditions.	§18 will be revised to confer such power on the MA if the AI demonstrates to the satisfaction of the MA that certain conditions are met, such as - (a) it is currently not practicable for the AI to include the position, or the part of the business which is the subject of the exclusion, in the relevant calculation; (b) the exclusion will not materially prejudice the calculation of the AI's regulatory capital for market risk; and (c) the AI has a reasonable plan and timetable to include that position, or that part of the business, in the use of the IMM approach.
2. §23 Exemption from section 17	**<u>Revocation of exemption from the requirement to calculate market risk capital charge</u>** To ensure effective operation of §22(1) and §23(1), the MA needs to have the power to revoke an exemption granted to an AI from the requirement to calculate market risk as soon as practicable upon notification from an AI that its market risk positions (as calculated according to the requirements of §22(2)) exceeded HK$60 million, or 6% of its total on-balance sheet and off-balance sheet exposures.	A new requirement will be incorporated in §23 such that the MA will have the power to revoke the market risk exemption status of an AI as soon as practicable upon notification from the AI that its market risk positions (as calculated according to the requirements of §22(2)) exceeded HK$60 million, or 6% of its total on-balance sheet and off-balance sheet exposures.

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BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
3. §281, 283(1) & 316(1) Interpretation of Part 8; Positions to be used to calculate market risk	**<u>Credit derivative contracts booked in the trading book</u>** Under Divisions 10 and 12 of Part 8 of the BCR, credit derivative contracts booked in the trading book are subject to market risk capital charge. This type of contract will be incorporated under §283(1) and §316(1) to improve the clarity of the definitions of the positions to be used to calculate market risk. For consistency purposes, the definition of "specific risk" in §281 will be revised accordingly. To simplify the wording used in the BCR, a new term "specific risk interest rate exposures" will be used to denote those interest rate exposures that are subject to market risk capital charge for specific risk (i.e. debt securities, debt-related derivative contracts and credit derivative contracts in the trading book).	§283(1) and §316(1) will be revised to explicitly mention that credit derivative contracts booked in the trading book are subject to market risk capital charge. The definition of "specific risk" in §281 will be revised to include the risk of loss, arising from changes in the price of credit derivative contracts owing to factors relating to the credit status of reference entities, in the value of the AI's trading book positions held in the credit derivative contracts. The new term "specific risk interest rate exposures" will be added to §281.
4. §287(2)(a) Calculation of market risk capital charge for specific risk	**<u>Offsetting criteria</u>** Amendment is proposed to align the wording in §287(2)(a) more closely with the wording of the relevant offsetting rules in paragraph 709(iii) of the Basel II framework.	§287(2)(a) will be revised and shortened along the lines that an AI may offset matched long and short positions in identical issues (including positions in derivative contracts).
5. §319 Multiplication factor	**<u>Determination of the number of back-testing exceptions</u>** Since the number of back-testing exceptions affects the level of plus factor to be used for calculating the market risk capital	A new requirement will be included in §319 along the lines that an AI shall not, without the prior consent of the MA, make any significant change to the approach it uses for the purposes of calculating the number of

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	charge by an AI (see §319(1)(b)), it is reasonable for the MA to have the power to require an AI to obtain the MA's prior consent before the AI makes any significant change to the approach for calculating the back-testing exceptions for capital adequacy purposes.	back-testing exceptions under §319(1)(b).

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I. Schedules to BCR

Schedule number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
1. Schedule 4 §2(c)(ix) Minimum requirements to be satisfied for approval under section 25 of these rules to use STO Approach or ASA Approach	Amendment is proposed to achieve consistent drafting style in line with other schedules within the BCR: Schedule 2 – 1(a) Schedule 3 – 1(a) Schedule 3 – 1(h)(i)	Line 4 of paragraph 2(c)(ix) will be revised such that "……. board of directors of the institution" will be read as "…… *board of directors (or a committee designated by the board) of the institution*."
2. Paragraph (g)(ii) of Schedule 9 Requirements to be satisfied for using § 229(1)(a) of these Rules	The HKMA is aware of cases in which the repurchase of securitized exposures under specified circumstances is a standard clause included in the securitization documentation for legitimate and sound commercial reasons (i.e. rather than to oblige the originating banks to repurchase the securitized exposures in response to a deterioration in the credit quality of the exposures). Inclusion of such clause per se presently disqualifies an originating AI from making use of §229(1)(a) for excluding the underlying exposures in a securitization transaction from the calculation of the risk-weighted amount of its credit exposures under Part 4, 5 or 6 (as the case requires) of the BCR by virtue of Paragraph (g)(ii) of Schedule 9.	Paragraph (g)(ii) of Schedule 9 will be modified to make allowance for obligations to repurchase underlying exposures where such obligations are undertaken for reasons which, in the MA's view, are legitimate and commercially sound.

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Schedule number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
3. Schedules 6, 8, 11 and 14 Tables of credit quality grades and corresponding ECAI ratings	Fitch Ratings has recently amended its rating scales. Changes have to be made to the relevant Schedules to the BCR to reflect the changes.	The rating notations of “CCC+” and “CCC-“ will be deleted from the rating scale of Fitch Ratings.

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J. Implementation issues common to some of the capital calculation approaches

BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
1. To be determined	**<u>Approval with conditions</u>** To confer power on the MA to attach conditions to his approval for an AI to use a prescribed approach for calculating credit risk, market risk or operational risk under the BCR. The proposed change aligns with longstanding practice in the exercise of powers by the MA under the BO and by other regulators in Hong Kong (such as the Securities and Futures Commission under the Securities and Futures Ordinance) in granting certain supervisory approvals (e.g. under §16 of the BO, the MA can where necessary attach conditions to authorization of an AI). It is also not uncommon for other major banking supervisors (e.g. UK, Australia, Canada and Singapore) to be given the power to impose conditions to an approval for their banks to use a specified approach for calculation of regulatory capital under Basel II. In this connection, there will be related amendments to the BCR to give the MA the power to amend or cancel the conditions attached to his approval, as well as to impose supervisory measures in case such conditions are not fulfilled.	Additional provisions will be added to the effect that:- (a) where an AI is granted an approval under the BCR to use a prescribed approach for calculating credit risk, market risk or operational risk, the MA may attach conditions to the approval, and subsequently amend or cancel any conditions so attached, as he considers it reasonable in all the circumstances of the case; and (b) where an AI fails to comply with any of the conditions attached to the MA's approval, it will be subject to such supervisory measures as may be determined by the MA (e.g. for an AI using the IRB approach, the measures specified in §10(5) of the BCR).

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BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
2. §71, §118, §165	**<u>Counterparty credit risk for certain exposures</u>** The Basel II framework provides that the counterparty credit risk exposure in respect of credit derivative contracts falling within the following categories can be regarded as zero: • Sold credit protection for which a capital charge has already been provided in respect of the credit risk of the reference obligation underlying the credit derivative contract concerned. • Bought credit protection in respect of which the CRM effect has already been recognized for risk-weighting purposes. The above special treatments for credit derivative contracts have not yet been incorporated into the BCR.	The relevant provisions in the BCR will be amended accordingly.
3. §73, §120, §166	**<u>Credit conversion factor ("CCF") for other off-balance sheet exposures</u>** Basel II allows banks to apply the CCFs that are applicable to "other commodity contracts" to forward contracts, swap contacts, purchased option contracts and similar derivative contracts that are not specified in Table 11 or Table 15 of the BCR (see Note 3 to paragraph 92(i) of Annex 4 of Basel II on p.274). To align with the Basel II requirements, it is proposed to revise the CCF for such contracts from 100% to a CCF applicable to "other commodity contracts", which range	The relevant provisions in the BCR will be amended to bring them in line with the Basel II framework such that • an off-balance sheet exposure, other than an OTC derivative transaction or credit derivative contract, which is not specified in Table 10, Table 14 and Table 20 will be subject to a CCF of 100%; • an OTC derivative transaction or a credit derivative contract which is not specified in Table 11 or Table 15 will be treated as "Debt security contracts or other commodity contracts" and

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BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR*
	from 10% to 15%.	subject to the applicable CCF (10%, 12% or 15%) as specified in item 5 of Table 11 or Table 15.
4. To be determined	**<u>Capital treatment for certain exchange-traded derivative contracts</u>** For the avoidance of doubt, it will be useful to clarify that an AI is not required to calculate a credit risk capital charge for a derivative transaction or a credit derivative contract if the transaction or contract is traded on an exchange and is subject to daily re-margining requirements of the relevant exchange.	Relevant provisions in the BCR will be revised to clarify that an AI is not required to calculate a credit risk capital charge for a derivative transaction or a credit derivative contract if the transaction or contract is traded on an exchange and is subject to daily re-margining requirements of the relevant exchange.

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