Annex A

HKMA's Responses to HKAB's comments

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Annex 2 – Enhancements to Basel II market risk framework			
1. General		The enhanced framework should focus on achieving the "right" capital requirement for a particular portfolio of risks, instead of a "higher" capital requirement. Increasing the capital requirement uniformly across all trading book activities could have the unintended consequence of reducing market liquidity by making it uneconomical for participants to trade in some markets.	• As revealed from the global financial crisis, the existing Basel II market risk framework has failed to adequately capture some key risks, in particular those associated with banks' holdings of securitization / resecuritization exposures in the trading book and the inability of the existing VaR modeling framework to adequately reflect the impact of prolonged and severe market stresses. • Thus, the current enhancements to the market risk capital framework are targeted at addressing these specific weaknesses through (i) imposing higher market risk capital charges on banks' holdings of securitization / resecuritization exposures and other less liquid positions in the trading book; and (ii) requiring more robust standards governing the valuation and modeling requirements for the calculation of market risk. Instead of increasing capital requirements uniformly across all trading book activities, the enhanced market risk capital framework will affect individual AIs differently, depending on the level of risk posed by their trading book activities. • The HKMA acknowledges the industry's concern on unintended consequences of the new capital requirements. In this regard, the BCBS is conducting a comprehensive quantitative impact study ("QIS") to assess the cumulative impact of various capital and liquidity standards proposed in

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			its December 2009 reform package as well as the trading book proposals finalised in July 2009. The BCBS will analyse the QIS results to ensure proper calibration of the standards. The HKMA is participating in this QIS exercise and will also conduct a local QIS covering a larger sample of AIs to better assess the potential impact of implementing the various requirements on the local banking sector.
2. III. 4 (a) (i)	Summary of Enhancements to Market Risk Capital Framework	If capital is based on the sum deriving from internal models (IMM), incremental risk charge (IRC) and stressed value-at-risk (sVaR), there will be a possibility of double counting and over-estimating of risks.	• The BCBS's decision not to take into account possible double-counting of risks in the revised market risk capital framework could reflect (i) its intention to provide flexibility to banks by not prescribing particular models for calculating the new risk metrics such as sVaR and IRC; and (ii) the lack of established methodology or consensus for dealing with the double-counting of risks satisfactorily within the framework. The HKMA will closely monitor future developments and follow any relevant guidance that may be issued by the BCBS in due course.
3. IV. (B) (B1)	Proposed amendments to Banking (Capital Rules) - Calculation of sVaR	sVaR does not meet the use test and dilutes the effectiveness of the current VaR by creating a duplicate risk metric. The current VaR market risk capital charge already requires stress testing and references are usually made to historical stress events when deciding the stress scenarios. The VaR methodology would also be reviewed by the Hong Kong Monetary Authority (HKMA) in the supervisory review process and the result forms the basis of the multiplier applicable in	• The sVaR, which takes into account a one-year observation period relating to significant losses, is required for addressing the issue that the existing VaR modeling framework might not have adequately captured those risks that have led to significant trading losses for some financial institutions during the crisis. The sVaR is meant to be a supplement to, rather than a substitute for, the current stress-testing requirements related to market risk calculations. Moreover, the sVaR deals with the VaR modeling issue directly under Pillar 1 while the focus of the supervisory review process under Pillar 2 is more on the adequacy of an AI's market risk management systems (including related stress-testing practices).

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		the market risk capital calculation. Hence, stress testing has already been taken into account under the existing framework. If, however, a different view is taken by the HKMA, it would help authorized institutions (AIs) to speed up the implementation process and avoid ambiguity of the newly introduced sVaR if the HKMA can specify which 12-month historical observation periods are acceptable to be used for the sVaR calculation.	 ● AIs should choose a period which is considered relevant and appropriate to their current market risk portfolios for calculating the sVaR. The period used must be approved by the HKMA and be regularly reviewed by AIs. As set out in the HKMA's consultation paper, a 12-month period relating to significant losses arising from the U.S. sub-prime crisis in 2007/2008 or the Asian financial crisis in 1997/1998 would adequately reflect a period of stress for many portfolios, although other periods relevant to AIs' current market risk portfolios should also be considered by them.
Annex 3 – Enhancements to Basel II securitization framework			
4. General		We would like the HKMA to clarify the definition of 'securitization transaction' in section 227 of the Banking (Capital) Rules (BCR). In BCR, 'securitization transaction' is defined as a transaction involving the tranching of credit risk associated with a pool of underlying exposures and in respect of which: i. there are not less than 2 different tranches; ii. payments to investors or other parties to the transaction depend on the performance of the	● Tranching of credit risk, as elaborated in the definition of "securitization transaction", involves subordination of tranches which determines the distribution of losses among the tranches during the life of the securitization transaction concerned. In other words, some tranches are providing credit enhancement to the other tranches. Other types of credit enhancement such as guarantee are usually not taken into account when considering whether there is tranching of credit risk. Given the complexity of securitization transactions, there is no hard-and-fast rule (e.g. based on the credit ratings of the tranches). Transactions have to be considered on a case-by-case basis.

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<tr><td></td><td></td><td>underlying exposures; and
iii. the subordination of tranches determines the distribution of losses during the life of the transaction.

We would be grateful for greater clarity on the meaning of 'tranching of credit risk associated with a pool of underlying exposures'. For example, when an AI established its positions on several senior tranches of MBS issued by Ginnie Mae where all tranches have ECAI ratings of AAA, and that this MBS has a total of 30 tranches, it is unclear whether the AI should classify its exposures on this MBS as securitization based on the legal form of the tranches of the MBS, or its credit risk rating.</td><td></td></tr>
<tr><td colspan="4">Annex 4 – Proposed amendments to Banking (Disclosure) Rules</td></tr>
<tr><td>5. Table 11</td><td>Market Risk: disclosures for banks using the internal models approach (IMA) for trading portfolios</td><td>Please clarify whether the reference of s.80 should be s.83 instead since s.80 is related to counterparty risk while table 11 refers to market risk.</td><td>• Your understanding is correct.</td></tr>
<tr><td colspan="4">Annex 5 – Proposed amendments to Banking (Capital) Rules arising from implementation issues</td></tr>
<tr><td>6. D2, E2</td><td>Part 4 of BCR on</td><td>Please clarify in each relevant section,</td><td>• In implementing this proposed amendment, the HKMA</td></tr>
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& F2	Standardized (credit risk) approach ("STC approach") for credit risk 2. BCR section 66 (1) – Other exposures which are not past due exposures Part 6 of BCR on Internal ratings-based approach ("IRB approach") for credit risk 2. BCR section 146- Other exposures	including the sections for bank exposures, securities firm exposures and corporate exposures, that whether exposures referred to in those sections are regulatory capital instruments.	plans to state clearly in sections 66 (re STC approach), 116 (re BSC approach) and 146 (re IRB approach) of the BCR that an AI's exposures which (i) fall within the definition of "other regulatory capital instrument" stipulated in section 35 of the BCR; and (ii) are not subject to capital deduction as required under section 48 of the BCR, should be classified as "other exposures which are not past due exposures" (for STC) or "other exposures" (for BSC and IRB) respectively and risk-weighted at 100%. There is no need for AIs to classify such exposures into other exposure classes for further capital charge calculation.
7. F9.	Part 6 of BCR on IRB approach for credit risk BCR Division 13 – Capital floor	The rationale for the proposed change is unclear as the capital add-on mentioned in Pillar 2 also aims at providing a capital buffer to withstand unforeseen distressed market conditions. It would be helpful if the HKMA could clarify how and on what principles it will collectively consider capital floor in Pillar 1 and capital add-on in Pillar 2. In addition, the existing BCR has	• The Basel I-based capital floor was originally introduced as a transitional measure for back-stopping any unduly large reduction in the regulatory capital of IRB banks under the Basel II framework. The BCBS announced in July 2009 its decision to keep the capital floor beyond 2009. This means the capital floor will continue to be applicable to all banks that currently adopt, or will adopt, the IRB approach indefinitely (or until the BCBS considers it appropriate to withdraw the floor requirement), regardless of the circumstances of individual AIs. • The BCBS's decision was understood to be a non risk-based

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		conferred power on the HKMA to extend the capital floor period to which an AI shall be subject beyond the third anniversary of the date on which it commenced using the IRB approach (or applying the capital floor period again) where the AI fails to fully comply with the sections under Part 6 of the BCR (section 255 of the BCR). We would like the HKMA to clarify the need to require an AI to continue to be subject to a capital floor after the transition period for issues not relating to the implementation, such as other broader prudential concerns that affect the overall financial soundness of the AIs. It would be more appropriate for those other prudential concerns to be addressed on a case-by-case basis as reflected in the Pillar 2 process when setting minimum capital requirements for individual AIs. Extending the capital floor period generally would defeat the risk-based approach underpinning the Basel II Accord. It is also onerous for AIs to maintain two sets of capital calculation systems simultaneously and continuously. The capital floor should not be a	measure to supplement the risk-based capital calculation parameters, with the aim of restricting reduction in the level of regulatory capital maintained by banks in light of the fact that many banks have not built up sufficient capital buffer to withstand unforeseen distressed conditions during the recent crisis. ● Having considered local circumstances and the proposed implementation approaches of some major jurisdictions in this respect, rather than a blanket application to all IRB AIs requiring them to observe the same level of capital floor on a permanent basis, the HKMA has decided instead to mainly broaden the circumstances, as set out in the proposal, under which the MA may require an AI to be subject to a specific level of capital floor. This will necessitate legislative amendment because at present, section 225 of the BCR only requires the capital floor to be applied to an IRB AI in the first 3 years of IRB implementation, or where the AI fails to comply with the IRB requirements set out in Part 6 of the BCR applicable to it. ● Use of the capital floor under Pillar 1 will be regarded as one of the supervisory tools (i.e. other than the supervisory review process under Pillar 2) that may be adopted by the MA to address prudential concerns identified in an AI. The MA will determine which of the tools should most suitably be used based on the nature and circumstances of each case. For instance, application of the capital floor can be a more direct and focused measure (versus a more broad-based capital add-on under Pillar 2) to address specific modeling or system issues associated with an AI's capital calculation approaches.

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		substitute for the careful consideration of the risks faced by individual AIs and the ways to manage and control such risks. It is suggested that the HKMA reconsider its proposal to amend the existing capital floor requirement in the BCR and instead place reliance on the Pillar 2 ICAAP and SRP processes.	
8. F10.	Part 6 of BCR on Internal ratings-based approach ("IRB approach") for credit risk BCR Schedule 2, s.1(i)(v) – Independent validation of significant changes to internal rating system	The amendment proposes to expand the scope of AIs' internal independent validation of their rating systems under paragraph 1(i)(v) of Schedule 2 to 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 HKMA under s. 8(4)(b) of the BCR. Typically, a Model Assessment Committee would be responsible for assessing each new or changed risk rating as regards its suitability for use after it has been validated and then advise the responsible approving committee before implementation. Model governance forms part of the Supervisory Review Process which should provide comfort	• Please note that section 8(4)(b) of the BCR already requires an AI to obtain the prior consent of the MA for any significant change to any rating system which is the subject of his approval under section 8(2)(a) of the BCR. This amendment merely proposes to subject any such "significant change" to an approved rating system to the AI's own independent validation process to ensure the continued robustness of its systems.

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		to the HKMA. It is therefore suggested that the HKMA rely on IRB bank's governance over model changes and be notified of changes approved within such framework. The proposed requirement of prior consent of the HKMA on any significant proposed change could significantly delay the change processes which may lead to undesirable risk and capital management outcomes.	
9. F11.	Treatment of credit-linked notes	Please advise the treatment for credit-linked notes with a basket of reference entities.	• The HKMA will take into account this comment when proposing the new BCR provisions in this regard.
10. J1.	Implementation issues common to some of the capital calculation approaches 1. Approval with conditions	It would be helpful if the HKMA could advise the principles that it will follow in imposing conditions on AIs with respect to the calculation approach used.	• Similar to the exercise of powers to attach conditions to his approval granted under specific sections of the Banking Ordinance (e.g. sections 16 and 70), the MA will have regard to the relevant factors of the application in question. For instance, the MA may grant approval for an AI to adopt the IRB approach subject to the AI's satisfactory rectification of minor weaknesses in its internal rating system within a specified timeframe. This will enable the HKMA to monitor the AI's corrective actions more effectively.
Annex 6 – Drafted revised Supervisory Policy Manual module on "Supervisory Review Process" (SRP)			
11. General		The HKMA suggests implementing the enhancements to Pillar 2 immediately after finalisation of the Paper. It will be more realistic and	• The revised SRP guideline is intended to assist AIs in further enhancing their existing systems for identifying and managing risks and for capturing risks in their internal

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		practical by giving AIs a transitional period, say one year, to allow proper implementation of the substantial changes proposed, especially the requirements to build up a firm-wide risk management framework into the risk management process and to develop an effective risk aggregation measurement with the support of MIS.	assessments of capital adequacy. Unlike brand new requirements, many enhancements set out in the revised guideline are based on risk management principles and concepts that have already been embedded in various supervisory guidelines issued by the HKMA. • Given that these enhancements are crucial for effective capital and risk management, AIs should implement the enhancements without delay, if they have not already done so. Nevertheless, should AIs need more time in completing system and process changes for implementing specific requirements, they may discuss and agree with the HKMA an implementation plan and timetable for the requirements concerned. The HKMA will mention this in its circular letter to AIs when the revised guideline is formally issued.
12. 3.2.11 4.2.6	Supervisory review of capital adequacy – Key factors for assessing capital adequacy Supervisory standards on CAAP – Board and senior management oversight	The HKMA requests AIs to address both short-term and long-term capital needs as well as capital adequacy goal. It would be helpful for the HKMA to provide a time span reference for AIs to set the "short-term" and "long-term" strategies.	• How to define the time span for setting "short-term" and "long-term" capital adequacy goals should be the decision of individual AIs. Moreover, such decisions may vary depending on AIs' business strategies, risk profiles and other circumstances. For example, some AIs may regard the time period of one to three years as short-term and beyond three years as long-term while some AIs may further differentiate the time period of three to five years as medium-term. • The HKMA does not intend to prescribe the time span for AIs which may not be suitable to all. Nevertheless, in reviewing an AI's CAAP, the HKMA will compare the practices adopted by the AI and its peers.

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13. 3.3.5	Supervisory review of capital adequacy – Determination of minimum capital adequacy ratio (CAR)	The SRP mentions that holding capital is not the sole method to guard against the risks faced by AIs and other risk mitigation measures, e.g. adequate systems and controls, may be needed. More guidance from the HKMA on how AIs could incorporate the situation of other risk mitigation measures into the determination of capital requirements for the relevant risks would be helpful.	• Whether additional capital is required to cover a particular type of risk largely depends on the level of such risk and the extent to which the risk level can be reduced by applying appropriate risk mitigation measures. For example, if an AI's liquidity risk mainly arose from poor risk management controls, and the AI holds additional liquidity as a risk mitigation measure in the course of rectifying the liquidity risk management weaknesses identified, the HKMA will have regard to the effectiveness of the risk mitigation measure (i.e. the extent to which liquidity risk is reduced by the AI's additional liquidity) when considering whether the AI needs to hold additional capital for its liquidity risk management weaknesses. The HKMA will also take into account the AI's effort and progress in strengthening its liquidity risk management framework. • The HKMA will incorporate the above example into subsection 3.3 of the revised SRP guideline as further guidance to AIs.
14. 4.1.5 4.3.2	Supervisory standards on CAAP – General Key elements of CAAP	The HKMA expects AIs to establish an internal capital adequacy assessment process to assess the capital needed to cover all material risks. It is suggested that the HKMA provide more guidance on identifying residual risks besides the eight inherent risks mentioned in the SRP.	• AIs are expected to have adequate policies and procedures in place for managing risks inherent in their business activities. Whether a particular risk faced by an AI is material is determined by a number of factors. For example, if the risk identified could lead to damaging or detrimental consequences on the AI's survival, reputation or business prospects, it is considered material. • Given that the business activities conducted by AIs vary substantially and decisions concerning the materiality of

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			risks identified are essentially a judgement call, it is inappropriate, if not impossible, for the HKMA to provide supervisory guidance to assist AIs in identifying all material risks other than the eight inherent risks mentioned in the SRP guideline.
15. 4.1.5 Annex C	Supervisory standards on CAAP – General Scoring worksheets to facilitate assessment under SRP	A scoring card system will be used by the HKMA in assessing the risk level of AIs. However, there is no guideline on how the scores will be linked to the setting of minimum CAR. It is suggested that the HKMA elaborate on how the scoring result should be related to the capital adequacy level.	• The HKMA considers that the SRP guideline should focus mainly on describing the conceptual SRP framework (of which the scoring system forms a part) and its underlying principles. AIs may refer respectively to subsections 3.2 and 3.3 of the revised SRP guideline for elaboration on the key assessment factors and assessment approach as well as the approach towards the setting of minimum CAR for AIs. Thus, the HKMA has no intention to publicly disclose the relative weightings given to the various common factors considered under the scoring system. Moreover, it should be noted that these weightings are subject to the HKMA's periodic review and change where necessary.
16. Annex D Section D1.2	General requirements	The proposed amendment of the frequency of stress tests from "at least annually" to "at least quarterly" should take the practicality of stress testing into account. It is not appropriate to stipulate a blanket frequency on stress testing for all areas of risk (credit, market and operational). AIs should have the flexibility in determining the frequency for stress testing each type	• AIs should conduct stress tests, especially firm-wide stress tests, to assess their vulnerabilities to possible adverse events or changes in market conditions as well as the need for them to hold additional capital to absorb losses if such events or changes occur. Recognising that market conditions can change rapidly, the HKMA considers that conducting stress tests "annually" cannot serve the purpose, and would normally expect AIs to conduct stress tests more frequently, say, on a "quarterly" basis. Nevertheless, an AI may be allowed to conduct stress tests less frequently if this is justified by its size and complexity of operations as well as

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		of risk area according to the level of risks faced by the AIs in that area.	the level of risk faced by the AI in individual risk areas. • For clarification purposes, subsection D1.2 of the revised SRP guideline will be amended and expanded as follows: "AIs should conduct regularly stress tests (especially firm-wide stress tests) that are appropriate for their size and nature of operations to assess their vulnerabilities to possible adverse events or changes in market conditions and the need for them to hold additional capital should such events or changes occur. Recognising that market conditions can change rapidly, AIs are normally expected to conduct stress tests on a quarterly basis. Depending on the nature of the major sources of risk identified and their possible impact on AIs' financial conditions, some of these stress tests (e.g. those relating to trading activities) may need to be carried out more frequently (say, daily or weekly). Nevertheless, an AI may be allowed to conduct stress tests less frequently if this is justified by the AI's size and complexity of operations as well as the level of risk faced by it in individual risk areas."
17. Annex F Section F2.3	Management of risk concentrations under CAAP – Supervisory requirements	AIs are required to assess the capital requirement for risk concentration across business lines, asset types, risk areas and geographical regions. As capital assessment for risk concentration is relatively new to the banking industry, we submit for more guidance from the HKMA on this new	• The level of capital required for risk concentrations should be determined according to the level of such risk maintained. AIs may refer to Annex F of the revised SRP guideline if they want to have more supervisory guidance on how to assess and manage risk concentrations under CAAP. The HKMA will monitor AIs' practices in this respect and, where necessary, provide further guidance to assist AIs in assessing and managing risk concentrations.

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Annex 7 – Guidance for implementation of the enhancements to Basel II			
18. Appendix	Prudent valuation guidance (b) Valuation methodologies – Marking to model	It is suggested that the HKMA provide more detailed guidance on handling the bid/offer market inputs, for example, the conditions for allowing pool level/sub-portfolio level valuation adjustments due to bid/offer market inputs.	• The HKMA will incorporate the relevant BCBS guidance in the proposed valuation guidelines. However, it should be noted that the BCBS's expanded prudent valuation guidance is "*not intended to require banks to change valuation procedures for financial reporting purposes*"[1].

[1] See para. 718(c) on p. 26 of the BCBS paper, *Revisions to the Basel II market risk framework* (July 2009).