<u>Annex 2</u>

<u>ADDITIONAL PROPOSED AMENDMENTS TO BANKING (CAPITAL) RULES (BCR) ARISING FROM IMPLEMENTATION ISSUES IDENTIFIED SUBSEQUENT TO INDUSTRY CONSULTATION IN SEPTEMBER 2009</u>

A. Part 2 of BCR on prescribed approach in relation to calculation of capital adequacy ratio

BCR section number	Issues on existing requirements / Rationale for proposed amendments	Proposed amendments to BCR
1. §12 Exemption of exposures	**<u>Exemption of non-securitization exposures from the use of internal ratings-based approach (IRB approach) for credit risk</u>** Authorized institutions (AIs) may apply for an exemption under §12 simultaneously with their application to use the IRB approach for credit risk calculation. §12(1) should be clarified to reflect this.	It is proposed that §12(1) be amended to refer to "uses" or "is applying to use".
2. §18 Authorized institution may apply for approval to use IMM approach to calculate its market risk	**<u>Amendment of the reference to §18(5) in §18(7)</u>** At present, §18(7) contains a reference to "an approval under subsection (5)" when in fact the approval referred to is actually granted under §18(2)(a) albeit for risk categories or businesses as referred to in §18(5). To clarify this, amendment of §18(7) is recommended.	§18(7) will be revised along the following lines: "For the avoidance of doubt, it is hereby declared that an AI which has an approval under subsection (2)(a) shall use the standardized (market risk) approach (STM approach) to calculate its market risk for any risk category or business which is not the subject of the approval."
3. §22 Exemption from §17	**<u>Manner in which de minimis exemption for market risk is granted under §22 / revoked under §23</u>** As explained below, amendment of <u>§22</u> and §23 is considered	It is proposed that amendments be made to §22 and §23 to enable the MA proactively to assess AIs' eligibility for exemption and to assess AIs'

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and §23 Revocation of exemption under §22	desirable to clarify certain ambiguities contained in the present wording and to provide the Monetary Authority (MA) with sufficient flexibility to exercise his exemption or revocation powers- (i) The term "demonstrates" in the opening sentence of <u>§22(1)</u> might be taken to suggest that an AI must <u>actively</u> apply for exemption from the calculation of market risk. In practice, this is not always the case. Amendment of §22 is thus proposed to make it clear that the MA may take the initiative to assess regularly the market risk positions of AIs, for the purpose of identifying AIs to which either (a) §22(1) exemption should be granted by virtue of their meeting the de minimis criteria; or (b) any previously granted exemption under §22(1) should be revoked under §23(1). (ii) Currently, §22(3) only allows the MA to assess an AI's market risk positions as at calendar quarter end dates. This has been found to be too rigid and somewhat impractical, especially in the case of market risk positions that may only sporadically exceed the thresholds specified under §22(1)(a)(ii) and (b)(ii). Amendment is thus proposed to allow the MA more flexibility to assess the market risk positions of AIs for a position date chosen by the MA for the purposes of §22(1) or §23(1).	market risk positions on dates selected by the MA.

B. Part 3 of BCR on capital base

BCR section number	Issues on existing requirements / Rationale for proposed amendments	Proposed amendments to BCR
1. §37(2)(c) Essential characteristics of core capital and supplementary capital and §42(1)(f) Supplementary capital of authorized institution	The BCBS Basel II framework and the capital rules of other jurisdictions do not explicitly require that to be included in a bank's supplementary capital, paid-up term preference shares or subordinated term debt should permit, without restrictions, the non-payment of a dividend or deferral of interest payments. §42(1)(g) and (h) reflects this position without referring to non-payment / deferral when listing the capital items which may be included in an AI's supplementary capital (in contrast for example to the position re perpetual subordinated debt where the deferral provision is clearly included in §42(1)(e)(vi)). However the more general description in §37 of the BCR effectively sweeps together perpetual and term subordinated debt when referring to deferral of interest requirements and arguably creates a mismatch and ambiguity between §37 and §42. On the other hand, the Basel II framework requires that perpetual subordinated debt and irredeemable cumulative preference shares (referred to in §42(1)(e) and (f) of BCR respectively) should allow service obligations to be deferred where the profitability of the bank would not support payment. §42(1)(e)(vi) reflects this position but §42(1)(f) does not. Therefore, §37(2)(c) and §42(1)(f) should be amended to maintain a level playing field between AIs in Hong Kong and banks elsewhere and to be consistent with international standards.	§37(2)(c)(i) and (ii) will be amended such that they should not apply to §42(1)(h) and (g) respectively. §42(1)(f) will be amended to add an additional condition that aligns with §42(1)(e)(vi).
2. §44	Under §44(2)(a)(i) and (ii) of the BCR, an AI should deduct from	• §44(2)(a)(ii) and §44(3) will be deleted.

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Provisions supplementary to §42(1)(b)	its core capital any cumulative unrealized losses below the cost of available-for-sale (AFS) securities and impairment losses in respect of AFS securities. Given that under IAS 39 impairment losses on AFS securities are recognised in the profit and loss account, the regulatory adjustment made to impairment losses as required under §44(2)(a)(ii) is redundant, and hence can be removed. §44(2)(b) provides that any unrealised gains on AFS securities (which are recognised directly in equity under IAS 39) shall not be used to offset any impairment losses in respect of those securities (that are recognised in the profit and loss account). For the avoidance of doubt, this section should be maintained but modified to reflect the deletion of §44(2)(a)(ii). §44(3) requires an AI to deduct from its supplementary capital any overall deficit arising from the revaluation of its holdings of AFS equities and debt securities falling within §42(1)(b)(i) (but excluding any losses falling within subsection (2)(a)). The drafting of §44(3) makes it clear that the section is not applicable to cumulative unrealized losses required to be deducted from core capital under §42(2)(a). Given that any losses arising from the revaluation of AFS securities would be captured under §44(2)(a), there appears to be no circumstances under which §44(3) might come into operation. Therefore, §44(3) should be removed to avoid any unintended ambiguity.	• §44(2)(b) will be modified in light of the deletion of §44(2)(a)(ii).

C. Part 6 of BCR on internal ratings-based approach

BCR section number	Issues on existing requirements / Rationale for the proposed amendments	Proposed amendments to BCR
1. §175(c) and §193(e) Integrity of rating process	**Use of overrides** In the HKMA's consultation conducted in September 2009, it was proposed that §155(e), which governs overrides relating to the use of internal rating systems by AIs in respect of corporate, sovereign and bank exposures, be enhanced. It is considered necessary to apply similar enhancements to the corresponding provisions under §175(c) in respect of retail exposures and §193(e) in respect of equity exposures.	It is proposed that similar provisions to those proposed for enhancing §155(e), i.e. 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 subject to approval at the appropriate level, be incorporated into both §175(c) and §193(e).
2. §202 Repo-style transactions	**Treatment for repo-style transactions booked in the trading book** The IRB approach for the credit risk capital treatment for repo-style transactions booked in the trading book should reflect the corresponding approaches prescribed in §76(a) under the standardized (credit risk) approach (STC approach) and in §123(a) under the basic approach.	To align the credit risk capital treatment for repo-style transactions booked in the trading book across the prescribed approaches for credit risk under the BCR, the following requirement currently specified in §76(a) and §123(a) will be incorporated into §202 under the IRB approach along the following lines: "An authorized institution shall calculate the risk-weighted amount of an exposure in respect of a repo-style transaction booked in its trading book by reference to Part 8 in any case where the transaction falls within paragraph (a) or (b) of the definition of "repo-style transaction" in section 2(1), or paragraph (d) of that definition where the collateral provided by the institution is in the form of

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		securities.”

D. Part 7 of BCR on credit risk for securitization exposures

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1. §262 Determination of risk-weights and §274 Effective number of underlying exposures	The simplified methodology for calculating the effective number of underlying exposures (N) is specified under §262(7) of the BCR which, by its terms, only applies to “re-securitization” transactions. However, the HKMA is now of the view that it would be more logical if the simplified methodology applies to securitization transactions in general, except for re-securitization transactions under the ratings-based method of the internal-ratings based (securitization) approach (IRB(S) approach) (in which case another set of higher risk-weights in the Basel II enhancements will apply thus rendering N irrelevant to the risk-weight determination).	§262(6), §262(7) and §274 will be amended accordingly to reflect the extended application of the simplified methodology as mentioned in the second column.
2. Division 5 Specific risk-weighting requirements under rating-based method and	How specific provisions made in respect of securitization exposures should be treated in the calculation of the risk-weighted amount for such exposures under the IRB(S) approach is not at present clearly reflected in the BCR. To further clarify and explain such treatment, new sections (say, under the heading of “Reduction in risk-weighted amounts”) are proposed to be incorporated at the beginning of Divisions 5 and 6 of Part 7.	Under the IRB(S) approach, any specific provision made in respect of a securitization exposure should be recognized through reduction in the risk-weighted amount. In the case of the ratings-based method under the IRB(S) approach, the amount by which the risk-weighted amount is reduced should be equal to the risk-weight of the exposure (determined in

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Division 6 Specific risk-weighting requirements under supervisory formula method		accordance with §262) multiplied by the amount of special provision made in respect of the exposure; and in the case of the supervisory formula method under the IRB(S) approach, the amount by which the risk-weighted amount is reduced should be equal to the risk-weight of the exposure (determined in accordance with §270) multiplied by the amount of special provision made in respect of the exposure.

E. Part 8 of BCR on market risk

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1. §287 Calculation of market risk capital charge for specific risk	**<u>Interest rate risk arising from exposures in respect of public sector entities (PSEs)</u>** Under paragraph 711(i) of the June 2006 Basel II framework[1], interest rate exposures arising from (i) debt securities issued by PSEs; and (ii) debt-related derivative contracts where the underlying debt securities are issued by PSEs (collectively referred to as "PSE exposures") can be included in the "qualifying" class of exposures for the purposes of calculation of market risk capital charge for specific risk of interest rate exposures. However, this treatment is not explicitly reflected in the BCR.	§287 will be amended to include investment grade PSE exposures into the "qualifying" class in Table 28. This is proposed to be achieved along the following lines: • By reference to §57(1)(a) regarding the treatment of domestic PSEs under the STC approach, rated PSE exposures will be mapped to a credit quality grade (CQG) which is one grade below that assigned to the sovereign of the jurisdiction in which that PSE is

[1] The BCBS document can be accessed at http://www.bis.org/publ/bcbs128.pdf .

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		incorporated. If the lowest CQG (i.e. CQG of 6) is assigned to the sovereign, the same CQG will be assigned to the PSE exposure in question. • Those rated PSE exposures to which a CQG of 2 or 3 is assigned will be included in the "qualifying" class, while the other rated or unrated PSE exposures will be included in the "non-qualifying" class, for the purposes of §287.
2. [new provision] Provisions supplementary to §317 - Calculation of market risk capital charge for foreign exchange (including gold) exposures	Currently, the exclusion of foreign exchange (FX) positions that meet the definition of "structural position" in §295(3) from the calculation of market risk (subject to consultation with the MA) is explicitly allowed under the STM approach but a similar allowance is not explicitly made under the internal models approach (IMM approach) in the BCR. Although the existing BCR provisions are in line with the requirements of the Basel II framework, the HKMA considers that it is not logical to differentiate between the STM approach and IMM approach in the application of the exclusion of FX structural positions. A number of overseas supervisors appear to have taken a similar view and have applied the provisions for exclusion of such positions more broadly to both the STM and IMM approaches. The HKMA intends to follow suit.	New provisions for excluding FX structural positions under the IMM approach will be incorporated into the BCR by mirroring the relevant provisions set out in §295(2) and (3) under the STM approach.