HONG KONG MONETARY AUTHORITY
香港金融管理局

Banking Policy Department *銀行政策部*

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Mr Ryan Fung
Chairman
The DTC Association
Unit 1704, 17/F, Bonham Trade Centre
50 Bonham Strand East
Sheung Wan
Hong Kong

Dear Mr Fung,

Basel Committee's Adjustments to Basel II Market Risk Framework and Additional Amendments to Banking (Capital) Rules (BCR) to address Implementation Issues

In September 2009 the HKMA consulted the Association on its proposals for implementing the enhancements to the Basel II framework issued by the Basel Committee in July 2009 and other changes to address implementation issues identified since the BCR took effect on 1 January 2007. I am writing to update the Association on changes to the HKMA's implementation proposals in response to the Basel Committee's announcement this June regarding its adjustments to the Basel II market risk framework[1], and to seek the Association's comments on some additional amendments to the BCR that the HKMA would like to propose to address implementation issues identified subsequent to the industry consultation last September.

[1] The press release is available on the BIS website (http://www.bis.org/press/p100618.htm).

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Adjustments to Basel II market risk framework

The Basel Committee announced on 18 June 2010 some adjustments to the document *Revisions to the Basel II market risk framework* (the market risk revisions) which was issued as part of the July 2009 reform package. These adjustments take into account the results of the comprehensive quantitative impact study conducted by the Committee this year in respect of the market risk revisions, as well as relevant comments made by national supervisors and the banking industry. The adjustments are highlighted below (see Annex 1 for more details):

- Under the original market risk revisions, the market risk capital charge for specific risk (i.e. the specific risk capital charge) of securitization exposures that do not qualify for inclusion in a correlation trading portfolio (CTP) should be based on the sum of capital charges for their net long and net short positions. However, the Basel Committee has now provided that, during the two-year transitional period following the implementation of the market risk revisions, the non-CTP securitization exposures may be subject to a lower specific risk capital charge determined by the larger of the capital charges for their net long and net short positions.

- The specific risk capital charge for an individual position in a credit derivative contract or securitization exposure may be limited to the maximum possible loss calculated in a manner prescribed by the Committee.

- The floor to the comprehensive risk charge for CTP positions under the internal models approach is set at 8% of the specific risk capital charge calculated for those positions according to the standardized (market risk) approach.

In addition, to ensure robust implementation and provide more time for banks and supervisors to review models subject to the market risk revisions, the coordinated start-date of the revisions is deferred by one year to no later than 31 December 2011. To avoid regulatory arbitrage, national supervisors are further allowed to implement the enhancements to the credit risk capital framework (which focus on the enhanced capital treatment for securitization exposures in the banking book), as set out in the document *Enhancements to the Basel II framework*, at the same time as the market risk revisions.

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In the light of the Basel Committee's recent announcement, the HKMA will accordingly incorporate the market risk adjustments detailed in Annex 1 into the BCR, and revise the implementation date of the proposed legislative amendments for both the July 2009 reform package and the implementation issues to 31 December 2011.

Additional BCR amendments to address implementation issues

Following the industry consultation in September 2009, the HKMA has identified the need for some additional amendments to the BCR as detailed in Annex 2. These amendments are mostly consequential or related to the incorporation of the BCR amendments earlier proposed, or have arisen from recent market developments. Subject to the comments of the Association, the HKMA intends to include these additional BCR amendments in the December 2011 amendment exercise.

HKMA's revised implementation plan

The HKMA is in the process of initiating the legislative amendments to the BCR and the Banking (Disclosure) Rules (BDR) as planned. As a result of the revised implementation schedule, the HKMA aims to conduct statutory consultation on the proposed amendments to the BCR and BDR in June 2011 pursuant to sections 98A and 60A of the Banking Ordinance. The parties to be consulted include the Banking Advisory Committee, Deposit-taking Companies Advisory Committee, Hong Kong Association of Banks, DTC Association and the Financial Secretary. The HKMA expects to table the amendment Rules at the Legislative Council in October 2011 for negative vetting so that the legislative amendments to the BCR and BDR can be completed before the end of December 2011.

We would be grateful if the Association's comments on the additional BCR amendments, and any other issues related to the revised implementation plan, could reach us by 24 September 2010. On-line access to this letter and its annexes is available via the HKMA's private web-site (http://www.stet.finnet.hk).

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I am writing in similar terms to the Chairman of the Hong Kong Association of Banks.

Yours sincerely,

Karen Kemp
Executive Director (Banking Policy)

Encl.

c.c. FSTB (Attn. Miss Natalie Li)