<u>Annex 2</u>

<u>Treatment of capital investment not subject to capital deductions under Schedule 4F and Schedule 4G</u>

1. Treatment of capital investments within thresholds

1.1 Paragraph 83 of the Basel 3 rules text specifies the treatment to be accorded to capital instruments held by a bank, where such instruments are issued by other banking, financial and insurance entities and (i) the holding bank does not own more than 10% of the issued common share capital of any of the issuing entities, and (ii) the aggregate amount of such instruments is within the 10% threshold of exemption from capital deduction. Such instruments should be treated "as per the market risk rules" if they are held in the trading book, or "as per the internal ratings-based approach, or the standardised approach (as applicable)" if they are held in the banking book. §1(8)(a) of Schedule 4F of the BCRs specifies the risk-weighting treatment of such instruments by cross-referring to Part 4, 5 or 6 of the Rules (which deal with the credit risk of exposures in the banking book respectively under the STC, the BSC or the IRB approach). We consider that it will provide more clarity if reference to Part 8 of the Rules is also inserted into §1(8)(a) of Schedule 4F to cater for any such instruments that are held in the trading book. Accordingly, the following change is proposed:

(a) In §1(8)(a) of Schedule 4F, substitute "Part 4, 5 or 6 of these Rules, as the case requires" with "Part 4, 5, 6 or 8 of these Rules, as the case requires".

2. Treatment of underwriting positions in capital investments

2.1 Under Basel 3 (paragraphs 80 and 84), short term underwriting positions in capital instruments issued by banking, financial and insurance entities, which are held for 5 days or less, can be excluded from capital deduction. To cater for the capital treatment (i.e. risk-weighting) for these positions, §1(6) of Schedule 4F (for "insignificant" capital investments) and §1(5) of Schedule 4G (for "significant" capital investments) of the BCRs require them to be subject to the applicable risk-weighting framework by referring to Part 4, 5 or 6 of the Rules (which deal with the credit risk of exposures in the banking book respectively under the STC, the BSC or the IRB approach). For similar reasons as discussed in paragraph 1.1, above, we consider it useful to insert reference also to Part 8 of the Rules to clarify that if any such deduction-exempted positions are held in the trading book, they should be subject to the market risk framework of the Rules. Accordingly, the following changes are proposed:

(a) In §1(6) of Schedule 4F, substitute "Part 4, 5 or 6 of these Rules, as the case requires" with "Part 4, 5, 6 or 8 of these Rules, as the case requires".

(b) §1(5) of Schedule 4G, substitute "Part 4, 5 or 6 of these Rules, as the case requires" with "Part 4, 5, 6 or 8 of these Rules, as the case requires".

<u>Annex 2</u>

<u>Schedule 4H - Transitional Arrangements in Relation to Banking (Capital) (Amendment) Rules 2012</u>

3. Phase-in arrangement for capital deductions

3.1 Under Basel 3, the 5 year phase-in arrangement in respect of items previously subject to deduction on a 50/50 basis from core capital and supplementary capital applies not only when such items are subject to deduction from CET1 capital, but also when they are subject to deduction from Additional Tier 1 capital or Tier 2 capital. However, the scope of Table C in subsection (5) of §3 (Capital deductions) is narrowly focused on deductions from CET1 capital and does not incorporate references to items subject to deduction from Additional Tier 1 capital or Tier 2 capital, as the case requires. In order to accurately reflect the policy intent, we propose to amend subsection (5) and the associated Table C as follows:

(a) Amend the text of subsection (5) and Table C as:

"(5) Table C applies, for the purposes of deduction from 1 January 2013 to 31 December 2017 (both dates inclusive), in respect of items that were subject to deduction on an equal basis from core capital and supplementary capital under section 48(2) of the pre-amended Capital Rules before 1 January 2013 but are subject to deduction from CET1 capital, <u>Additional Tier 1 capital or Tier 2 capital, as the case requires</u>, on and after 1 January 2013.

Table C

Deductions from 1 January 2013 to 31 December 2017 (both dates inclusive)

Date from which deduction is to be made	Amount to be deducted from CET1 capital, Additional Tier 1 capital or Tier 2 capital, as the case requires, expressed in percentage points	Remaining amount to be deducted on an equal basis from Tier 1 capital and Tier 2 capital expressed in percentage points
1 January 2013	0%	100%
1 January 2014	20%	80%
1 January 2015	40%	60%
1 January 2016	60%	40%
1 January 2017	80%	20%

4. Capital instruments that no longer qualify for inclusion in capital base

4.1 Schedule 4H specifies transitional arrangements for the determination of an AI's capital base under the Basel 3 standards. Specifically, §5 of the Schedule provides the transitional arrangements for the phasing-out of extant capital instruments (other than common equity) which were included in an AI's capital base immediately before 1 January 2013 but which were issued after 12 September 2010. Under Basel 3, these instruments must satisfy all of the required criteria set out in Schedule 4B or 4C of the BCR, except for the requirement relating to conversion or write-down at the point of non-viability, in order to be eligible for phase-out over 10-years. However, this was not correctly transposed into §5(2)(b)(i) and (ii) of Schedule 4H because of an erroneous cross reference. The correct reference should have been "section 1(q)" instead of "section 1(p)" in §5(2)(b)(i), and "section 1(k)" instead of "section 1(j)" in §5(2)(b)(ii). We therefore propose to rectify the error by making the following corrections:

(a) In §5(2)(b)(i), substitute "(excluding section 1(p) of that Schedule)" with "(excluding section 1(q) of that Schedule)"; and

(b) In §5(2)(b)(ii), substitute "(excluding section 1(j) of that Schedule)" with "(excluding section 1(k) of that Schedule)".