HONG KONG MONETARY AUTHORITY
香港金融管理局

Our Ref.: B1/15C
B9/75C
S4/12C

20 December 2013

The Chief Executive
All Locally Incorporated Authorized Institutions

Dear Sir/Madam,

**Internal Ratings-based Approach : Revised Capital Floor Requirements**

I am writing to inform you of changes to the capital floor requirements applicable to locally incorporated authorized institutions ("AIs") using the internal ratings-based approach ("IRB approach") to calculate regulatory capital for credit risk, and the Monetary Authority's approach to applying these revised requirements.

The main purpose of introducing these changes is to better align the existing capital floor requirements under the Banking (Capital) Rules ("BCR") with the prevailing capital standards issued by the Basel Committee on Banking Supervision ("Basel Committee"). The changes will be relevant not only to AIs already using the IRB approach but also to AIs that plan to apply for the Monetary Authority's approval to use the IRB approach in the future.

***Background***

Capital floors were originally introduced within the Basel II regulatory capital framework as a transitional measure[1] with a view to limiting the amount of capital reduction upon the transition of a bank from Basel I to the "advanced approaches" (which include the IRB approach for credit risk) under Basel II, and allowing time for supervisors and banks to rectify any implementation issues identified during the transitional period from 2007 to 2009. In response to concerns arising during the global financial crisis, however, the Basel Committee announced in a press release in July 2009 that it "agreed to keep in place the Basel I capital floors beyond the end of 2009"[2].

[1] See paragraphs 45 to 49 of the document entitled *International Convergence of Capital Measurement and Capital Standards (A revised framework)* issued by the Basel Committee in June 2006.

[2] See the press release of the Basel Committee at http://www.bis.org/press/p090713.htm.

To accommodate this decision of the Basel Committee, sections 225 and 226 of the BCR were amended to enable the Monetary Authority to retain or reinstate the capital floors provided for in Division 13 of Part 6 of the BCR, and to make appropriate adjustments to the calculation of capital floors, for so long as the Monetary Authority is satisfied that the prevailing Basel capital standards require a capital floor to continue to be applied to entities using the IRB approach.

***Measures to align with prevailing Basel capital standards***

The capital floor requirements in the BCR as adopted in 2007 reflect the original "transitional" nature of the capital floors by only requiring AIs adopting the IRB approach to be subject to the floors for the first three years of IRB adoption (unless there are specific prudential concerns with a given IRB AI that warrant an extension or re-application of the requirements in its specific case). Moreover, because the Monetary Authority elected in 2007 to go beyond the Basel II standard by requiring AIs transitioning to the IRB approach to calculate capital floors for a period of three years from whenever they commenced use of the IRB approach (rather than just for the original transitional period from 2007 to 2009), the Monetary Authority introduced, in section 226 of the BCR, a set of different adjustment factors (i.e. different from the "transition" factors in the Basel standard) to be used in the capital floor calculation by those AIs that started using the IRB approach after the end of the original transitional period (2007 -2009)[3].

Whilst the use of capital floors or benchmarks on a more permanent basis is still under consideration and discussion at the Basel Committee, including in the context of the Basel Committee's work on simplicity and comparability[4], it appears unlikely that the Basel Committee will come to a final decision on any future role and use of permanent capital floors in the very near term. In the light of this, the Monetary Authority considers it appropriate, through the exercise of the Monetary Authority's powers under sections 225(4A) and 225(6) of the BCR, to implement certain changes to the capital floor requirements currently in the BCR with a view to maintaining those transitional floors in existence beyond the first three years of an AI's IRB implementation and thereby broadly adhering to the existing Basel capital standard (being the Basel II document referred to in footnote 1 read together with the July 2009 press release referred to in footnote 2).

[3] These adjustment factors are lower than those prevailing for AIs that migrated to the IRB approach during the transitional period from 2007 to 2009 in order to compensate for the effect of requiring AIs transitioning to the IRB approach after 2009 to include the calculation of operational risk on both sides of the capital floor calculation (i.e. floor amount of capital and actual amount of capital).

[4] See paragraphs 60 to 64 of the discussion paper, *The regulatory framework: balancing risk sensitivity, simplicity and comparability*, issued by the Basel Committee in July 2013.

For this purpose, the Monetary Authority will issue notices, under section 225(6) of the BCR, to individual AIs that are already using the IRB approach requiring them to continue applying, or again apply, the capital floor requirements, as the case may be, in the manner specified in the notices until such time as the Monetary Authority becomes satisfied that the Basel Committee's capital standards no longer require a capital floor to be applied; or the AI ceases to use the IRB approach; or the BCR are amended to remove the original "transitional" capital floor requirements in Division 13 of Part 6 (albeit that amendments to the BCR might provide for the application of a permanent floor or benchmark to which the AI might be subject) ("a transitional floor termination event"). Where necessary, a grace period will be given to individual AIs to allow sufficient time for them to comply with the revised requirements.

An AI that obtains the Monetary Authority's approval to use the IRB approach after the date of this letter will be required to comply with the capital floor requirements set out in section 226 of the BCR, that are applicable to AIs that start to use the IRB approach after the original transitional period (i.e. 2007 to 2009), until the occurrence of a transitional floor termination event (as outlined in the preceding paragraph), <u>except</u> that the following adjustment factors will be applicable (instead of those specified in the last row of Table 23 in the BCR):

(i) for the first year of implementation of the IRB approach: 90%; and
(ii) for the second year of implementation of the IRB approach and each year thereafter: 80%.

These changes will be effected by way of a notice in writing issued by the Monetary Authority to the AI concerned under section 225(6), and pursuant to section 225(4A), of the BCR.

To avoid doubt, the issue of any notice by the Monetary Authority under section 225(6) of the BCR will not restrict or prejudice any exercise, or any further exercise, by the Monetary Authority of any of his other powers under the BCR in relation to capital floors or otherwise.

If you have any questions relating to this letter, please contact Ms Rita Yeung on 2878 1388 or Ms Echo Chan at 2878 1558.

Yours faithfully,

Karen Kemp
Executive Director (Banking Policy)