Q.1 It has been the HKMA's general policy that an entity which intends to hold 50% or more of the share capital of a deposit-taking company ("DTC") incorporated in Hong Kong should be a well established bank or other supervised financial institution. How does this policy apply to a non-bank or non-regulated entity which intends to become a majority or minority shareholder controller of a non-bank owned DTC incorporated Hong Kong?

A.1 For prudential reasons, it remains our preference for the share capital of a DTC to be owned at least 50% by a well established bank or other supervised financial institution.

However, if a non-bank or non-regulated entity intends to become a majority or minority shareholder controller of a non-bank owned DTC incorporated in Hong Kong, we would be prepared to exercise some flexibility under the general policy, provided that such an entity, like all other applicants to become shareholder controllers of an authorised institution, must satisfy the HKMA that it is a fit and proper person. In considering whether the applicant is fit and proper, we will take into account a number of factors such as the applicant's reputation, financial strength and management quality, etc., and its business plan for the DTC. A description of how the application is to be considered under each of these factors is set out in Chapter 4 of the Guide to Applicants issued by the HKMA.

Such flexibility will be applied only to DTCs which are already owned by non-bank entities. It will help to retain non-bank owned DTCs within the HKMA's supervisory framework without increasing the number of such DTCs. There are 10 such DTCs in Hong Kong at present.

Q.2 How should an authorised institution report in the Return of Capital Adequacy Ratio (Form MA(BS)3) ("CAR Return") the revaluation gain or loss arising from securities (both debt and equity) not held for trading purposes under the "alternative treatment" prescribed in SSAP24 "Accounting for investments in securities"?

A.2 Under the "alternative treatment" of SSAP24, securities which are not held for trading purposes should be measured at fair value and any gain or loss should be recognised directly in equity (in a revaluation reserve account holding such gain or loss) until disposal.

Under the current legal framework, the revaluation reserve arising from securities not held for trading purposes under the "alternative treatment" does not meet the definition of "latent reserves" set out in the Third Schedule of the Banking Ordinance[1] and should not therefore be reported in Item (i) of Part I of the CAR Return. Instead, it should be included (at full value) in item (d), "Reserves" of the CAR Return and treated as "Category I – Core Capital". An overall revaluation deficit under the "alternative treatment" should be deducted from other reserves reported in Item (d) of Part I of the CAR Return.

The above treatments are temporary. The HKMA will amend the Third Schedule to include the revaluation reserves arising from such securities in "Category II – Supplementary Capital".

1 This is because the revaluation reserve is incorporated into the accounts and is therefore not "latent".

Q.3 Why does the HKMA consider it necessary to amend the Third Schedule of the Banking Ordinance with regard to the revaluation reserves on securities not held for trading purposes?

A.3 The HKMA is concerned about the increase in the volatility of core capital if revaluation gains on non-trading securities are included at their full value in "Category I – Core Capital". Similar to the present treatment of latent reserves, it seems more appropriate for such gains to be included in "Category II – Supplementary Capital" at an appropriate discount.

Q.4 How should an authorised institution report in the Return of Capital Adequacy Ratio (Form MA(BS)3) ("CAR Return") the latent reserves on listed securities which are classified as "investment securities" under the "benchmark treatment" prescribed in SSAP24 "Accounting for investments in securities"?

A.4 Latent reserves arising from the difference between the market value and the book value of the listed equity securities which are classified as "investment securities" under the "benchmark treatment" of SSAP24 should continue to be reported at a discount of 55% in item (i) of Part I of the CAR Return. Where there is a net revaluation deficit, this should be reported in this item with a negative sign for deduction from other supplementary capital items.

However, latent reserves arising from investments in debt securities should not be reported as supplementary capital in the CAR Return.