

First draft (Second batch)

(re: Part 4 – Calculation of Credit Risk (Basic Approach))

CAPITAL RULES

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CAPITAL RULES

(Made by the Monetary Authority under section 98A of the Banking Ordinance (Cap. 155)
as amended by the Banking (Amendment) Ordinance 2005)

PART 1

PRELIMINARY

[1. Commencement

These Rules shall come into operation on a day to be appointed by the Secretary for Financial Services and the Treasury by notice published in the Gazette.]

2. Interpretation

(1) In these Rules, unless the context otherwise requires -

"alternative standardized approach" (), in relation to the calculation of an authorized institution's operational risk, means the method of calculating that risk set out in *Division 3 of Part 5*;

"ASA" () means the alternative standardized approach;

"asset sale with recourse" (), in relation to an authorized institution, means an asset sale transaction where the credit risk of the asset sold remains with the institution because the holder of the asset is entitled to put the asset back to the institution within a period agreed, or under circumstances agreed, under the transaction;

"bank" () means -

- (a) an authorized institution except an authorized institution the authorization of which is for the time being suspended under section 24 or 25 of the Ordinance; or
- (b) a bank incorporated outside Hong Kong which is not an authorized institution except such a bank -
 - (i) which, in the opinion of the Monetary Authority, is not adequately supervised by the relevant banking supervisory authority; or
 - (ii) the licence or other authorization of which to carry on banking business is for the time being suspended;

"banking book" (), in relation to an authorized institution, means all the institution's on-balance sheet assets and off-balance sheet exposures except such assets and exposures which are required to be recorded in the institution's trading book;

"basic approach" (), in relation to the calculation of an authorized institution's credit risk, means the method of calculating that risk set out in *Part 4*;

"basic indicator approach" (), in relation to the calculation of an authorized institution's operational risk, means the method of calculating that risk set out in *Division 1 of Part 5*;

"BIA" () means the basic indicator approach;

"BSA" () means the basic approach;

"business day" (), in relation to country (including Hong Kong), means any day other than –

- (a) a public holiday; or
- (b) day on which the financial markets are not generally open for business,

in that country;

"calendar quarter" () means a consecutive period of 3 calendar months ending on the last day of March, June, September or December;

"cash items" (), in relation to an authorized institution, means all or any of the following -

- (a) legal tender notes or other notes, and coins, representing the lawful currency of a jurisdiction held by the institution;

- (b) the institution's holdings of Government certificates of indebtedness for the issue of legal tender notes;
- (c) gold bullion -
 - (i) held by the institution; or
 - (ii) held on an allocated basis for the institution by another person,
to the extent that the gold bullion is backed by gold bullion liabilities;
- (d) gold bullion held for the institution, on an unallocated basis, by another person, to the extent that the gold bullion is backed by gold bullion liabilities;
- (e) gold bullion -
 - (i) held by the institution; or
 - (ii) held for the institution,
which is not backed by gold bullion liabilities;
- (f) cheques, drafts and other items drawn on other banks that are -
 - (i) payable to the account of the institution immediately upon presentation; and
 - (ii) in the process of collection;
- (g) unsettled clearing items of the institution that are being processed through any interbank clearing system in Hong Kong;
- (h) positive current exposure incurred by the institution from transactions -

- (i) in securities (other than repo-style transactions), foreign exchange instruments, and commodities that are entered into on a delivery-versus-payment basis; and
 - (ii) that are outstanding up to and including the 4th business day after the due settlement date in respect of the transaction concerned; or
- (i) amounts receivable, and positive current exposure incurred, by the institution from transactions -
- (i) in securities (other than repo-style transactions), foreign exchange instruments, and commodities that are entered into on a non-delivery-versus-payment basis; and
 - (ii) that are outstanding up to and including the 4th business day after the due settlement date in respect of the transaction concerned;

"collective investment scheme" () -

- (a) subject to *paragraph (b)*, means a collective investment scheme within the meaning of *Part 1 of Schedule 1* to the Securities and Futures Ordinance (Cap.571);
- (b) does not include a restricted collective investment scheme;

"comprehensive approach" (), in relation to collateral,

means;]

"corporate" () means -

- (a) a partnership or limited company; or

- (b) an unincorporated business owned by a single person,

that is neither -

- (c) a public sector entity, bank or securities firm; nor
- (d) a borrower to which the institution has an exposure falling within the definition of "regulatory retail exposure";

"counter-guarantee" (), in relation to an authorized institution, means a guarantee (or other undertaking) given by one party for the payment of money by a guarantor upon the guarantor being required to make payment under the terms of a guarantee given by the guarantor to the institution in relation to the exposure of the institution to a third party;

"country" () includes -

- (a) subject to *paragraph (b)*, any part of a country; and
- (b) any jurisdiction except a restricted jurisdiction;

"credit conversion factor" (), in relation to an off-balance sheet exposure of an authorized institution, means a percentage by which the principal amount of the exposure is multiplied in obtaining the credit equivalent amount of the exposure;

"credit default swap" () means a credit derivative contract under which the protection buyer pays a fee to the protection seller in return for compensation in the event of a default (or similar credit event) by a reference entity;

"credit derivative contract" () means a forward, swap, option or similar derivative contract entered into by 2 parties with the intention to transfer credit

risk in relation to an underlying obligation from one party ("protection buyer") to the other party ("protection seller");

"credit equivalent amount" (), in relation to an off-balance sheet exposure of an authorized institution, means the value obtained by -

- (a) in the case of an exposure that is not an OTC derivative transaction or credit derivative contract, multiplying the principal amount of the exposure, after deducting any specific provisions applicable to the exposure, by the applicable credit conversion factor;
- (b) in the case of an exposure that is an OTC derivative transaction or credit derivative contract, adding the current exposure of the OTC derivative transaction or credit derivative contract, as the case may be, to the potential exposure of the OTC derivative transaction or credit derivative contract, as the case may be;

"credit event" (), in relation to a credit derivative contract, means an event specified in the contract which, if it occurs, obliges the protection seller to make a payment to the protection buyer;

"credit-linked note" () means a form of structured note with an embedded credit default swap which allows the issuer of the note ("protection buyer") to transfer credit risk to the buyer of the note ("protection seller");

"credit protection" (), in relation to an exposure of an authorized institution, means the protection afforded to the exposure by recognized credit risk mitigation;

"credit protection covered portion" () means the credit protection covered portion referred to in *section 36(1)(a)*;

"credit quality grade" () means a grade represented by the numeral 1, 2, 3, 4, 5 or 6 to which the credit assessment of an ECAI is mapped for determining the appropriate risk-weight for an on-balance sheet asset or off-balance sheet exposure of an authorized institution;

"credit risk" (), in relation to an authorized institution, means the institution's credit risk as referred to in paragraph (a) of the definition of "capital adequacy ratio" in section 2(1) of the Ordinance;

"currency mismatch" (), in relation to an exposure of an authorized institution, means the exposure and the credit protection, if any, afforded the exposure are denominated in different currencies;

"current" () -

(a) in relation to an ECAI issuer rating, means the credit assessment rating concerned –

(i) has not been withdrawn; and

(ii) is not currently suspended,

by the ECAI which assigned that credit assessment rating;

(b) in relation to an ECAI issue specific rating, means -

(i) the credit assessment rating concerned –

(A) has not been withdrawn; and

(B) is not currently suspended,

by the ECAI which assigned that credit assessment rating;

and

- (ii) the debt obligation to which that credit assessment rating relates is still outstanding;

"current exposure" (), in relation to an off-balance sheet exposure of an authorized institution which is an OTC derivative transaction ("existing transaction") or credit derivative contract ("existing contract"), means the replacement cost -

- (a) which would be incurred by the institution if it were required to enter into another OTC derivative transaction or credit derivative contract, as the case may be, to replace the existing transaction or existing contract, as the case may be, with another counterparty with substantially the same economic consequences for the institution; and
- (b) calculated by marking - to - market the existing transaction or existing contract, as the case may be, and -
 - (i) if the resultant value is positive for the institution, taking the resultant value of the existing transaction or existing contract, as the case may be;
 - (ii) if the resultant value is negative for the institution, taking the resultant value of the existing transaction or existing contract, as the case may be, as zero;

"debt securities" () mean any securities other than shares, stocks or import or export trade bills;

"delivery-versus-payment basis" (), in relation to a transaction, means the service or thing provided under the transaction and the payment therefor occur simultaneously;

"direct credit substitute" (), in relation to an authorized institution -

(a) means an irrevocable off-balance sheet exposure of the institution which carries the same credit risk to the institution as a direct extension of credit by the institution; and

(b) includes -

(i) guarantees by the institution;

(ii) standby letters of credit serving as financial guarantees for loans;

(iii) acceptances; and

(iv) financial liabilities arising from the selling of credit protection under credit derivative contracts in the form of total return swaps or credit default swaps booked in the institution's banking book;

"domestic currency claim" (), in relation to an authorized institution, means a claim by the institution which is -

(a) denominated in the local currency of the obligor under the claim; and

(b) funded by liabilities entered into by the institution in that currency;

"domestic public sector entity" () means a public sector entity referred to in *paragraph (a)* of the definition of "public sector entity";

"ECAI" () means an external credit assessment institution;

"ECAI issuer rating" (), in relation to any person (howsoever described), means the long-term credit assessment rating assigned to the person by an ECAI;

"ECAI issue specific rating" (), in relation to a debt obligation issued or undertaken by a person (howsoever described), means [.....];

"ECAI rating" () means -

- (a) an ECAI issuer rating; or
- (b) an ECAI issue specific rating;

"equity contract" () means a forward, swap, option or similar derivative contract the value of which is derived from the value of underlying equities or equity indices;

"exchange controls" () means controls or restrictions imposed by the government of a country on the exchange of the currency of that country for the currency of another country;

"Exchange Fund" () means the fund established under section 3 of the Exchange Fund Ordinance (Cap. 66);

"exchange rate contract" () -

- (a) means a forward foreign exchange, cross-currency interest rate swap, currency option or similar derivative contract; and

- (b) includes a forward, swap, option or similar derivative contract the value of which is derived from the value of gold;

"external credit assessment institution" () means -

- (a) [Standard and Poor's Corporation];
- (b) [Moody's Investors Service, Inc.]; or
- (c) Fitch Ratings Ltd.;

"first-to-default credit derivative" () means a credit derivative contract under which -

- (a) the protection buyer obtains credit protection for a basket of reference [entities]; and
- (b) the first default among the reference [entities] triggers the credit protection and terminates the contract;

"foreign public sector entity" () means a public sector entity referred to in *paragraph (b)* of the definition of "public sector entity";

"forward asset purchase" (), in relation to an authorized institution -

- (a) means a commitment by the institution to purchase at a specified future date, and on pre-arranged terms, a loan, security or other asset from another party; and
- (b) includes a commitment under a put option written by the institution;

"forward forward deposit placed" (), in relation to an authorized institution, means an agreement between the institution and another party whereby the institution will place a deposit at an agreed rate of interest with the party at a specified future date;

"gold bullion held on an allocated basis" (), in relation to an authorized institution, means gold bullion -

- (a) held by a person other than the institution;
- (b) held for the institution; and
- (c) which is separately ascertainable;

"gross income" (), in relation to the calculation of an authorized institution's operational risk using the BIA, STO or ASA, means the sum of the institution's net interest income and non-interest income before the deduction from any such income of -

- (a) the operating expenses of the institution (including any expenses incurred for outsourcing services); and
- (b) any collective provisions and specific provisions made by the institution;

"group of companies" () means group of companies within the meaning of section 2(1) of the Companies Ordinance (Cap. 32);

"haircut" (), in relation to an authorized institution, means an adjustment to be applied to the credit protection held by the institution, or the institution's exposure, to take into account possible future price fluctuations or fluctuations in exchange rates;

"Hong Kong Accounting Standard" () means an accounting standard issued by the Hong Kong Institute of Certified Public Accountants pursuant to section 18A of the Professional Accountants Ordinance (Cap. 50);

"interest expenses" (), in relation to the calculation of an authorized institution's operational risk, means the sum of -

- (a) the interest paid by the institution on its interest-bearing liabilities;
- and
- (b) the accrued interest payable by the institution on its interest-bearing liabilities;

"interest income" (), in relation to the calculation of an authorized institution's operational risk, means the sum of -

- (a) the interest received by the institution on its interest-bearing assets;
- and
- (b) the accrued interest receivable by the institution on its interest-bearing assets;

"interest rate contract" () means a single-currency forward rate, interest rate swap, interest rate option or similar derivative contract;

"internal ratings-based approach" (), in relation to the calculation of an authorized institution's credit risk, means the method of calculating that risk set out in *sections* [..];

"IRB" () means the internal ratings-based approach;

"loans and advances in the commercial banking business line" (), in relation to the calculation of an authorized institution's operational risk, means the amounts drawn down and for the time being outstanding in respect of borrowers from the institution who, or exposures of the institution which, fall into any of the following categories of exposures -

- (a) corporate;
- (b) sovereign;
- (c) bank;
- [(d) specialised lending;]
- [(e) small and medium-sized entities treated as corporate borrowers under the use of the IRB to calculate an authorized institution's credit risk;]
- (f) purchased receivables due from corporate borrowers; and
- (g) book value of securities booked in the institution's banking book;

"loans and advances in the retail banking business line" (), in relation to the calculation of an authorized institution's operational risk, means the amounts drawn down and for the time being outstanding in respect of borrowers from the institution who, or exposures of the institution which, fall into any of the following categories of exposures -

- (a) retail borrowers (including borrowers under residential mortgage loans);
- (b) small businesses treated as retail borrowers under the use of the STC to calculate an authorized institution's credit risk;
- (c) small and medium-sized entities treated as retail borrowers under the use of the IRB to calculate an authorized institution's credit risk; and
- (d) purchased receivables due from retail borrowers;

"local currency" (), in relation to a country, means the currency issued by the central government, the central bank, the monetary authority, or an authorized note-issuing bank, of that country;

"long-term ECAI issue specific rating" (), in relation to a debt obligation issued or undertaken by a sovereign, bank, securities firm or corporate, means a long-term credit assessment rating assigned to the obligation by an ECAI;

"main index" () means an index by reference to which futures contracts or options contracts are traded on a recognized exchange;

"market risk" (), in relation to an authorized institution, means the institution's market risk as referred to in paragraph (b) of the definition of "capital adequacy ratio" in section 2(1) of the Ordinance;

"mark - to - market" (), in relation to any transaction, contract or recognized credit risk mitigation, means the revaluation of the transaction, contract or recognized credit risk mitigation, as the case may be, at current market rates;

"minimum holding period" (), in relation to collateral or thing held by an authorized institution, or by another person, for the institution's benefit (howsoever expressed), means a period -

- (a) reasonably likely to be required by the institution to realise the collateral or thing;
- (b) commencing on the date of the default by the counterparty giving rise to the right on the part of the institution to liquidate the collateral or thing; and

- (c) terminating on the business day (being a day which is not a public holiday in any relevant market for the collateral or thing) on which the institution would be reasonably likely to be able to realise the collateral or thing;

"net credit exposure" (), in relation to an on-balance sheet asset or off-balance sheet exposure of an authorized institution, means the institution's exposure to the counterparty after taking into account any recognized credit risk mitigation and deducting any specific provisions in respect of the on-balance sheet asset or off-balance sheet exposure, as the case may be;

"net interest income" (), in relation to the calculation of an authorized institution's operational risk, means the interest income of the institution after deducting the interest expenses of the institution;

"nettable" (), in relation to an on-balance sheet asset or off-balance sheet exposure of an authorized institution (howsoever described), means the asset or exposure, as the case may be, is subject to a valid bilateral netting agreement;

"non-interest income" (), in relation to the calculation of an authorized institution's operational risk -

- (a) subject to *paragraph (b)*, means -
 - (i) income recognized by the institution from -
 - (A) gains minus losses arising from the institution's trading in foreign currencies, exchange rate contracts, interest rate contracts, equity contracts,

- precious metal contracts, other commodity contracts,
credit derivative contracts and securities;
- (B) dividends recognized by the institution from its
shareholdings in other companies; and
- (C) fees and commissions recognized by the institution
(including any fees and commissions recognized by
the institution for insourcing services); and
- (ii) any other income (except interest income) arising in the
ordinary course of the business of the institution;
- (b) does not include -
 - (i) reversals of -
 - (A) write-downs of inventories, property, plant and
equipment of the institution; or
 - (B) provisions for bad and doubtful debts of the
institution;
 - (ii) income recognized by the institution from disposals of
items of property, plant and equipment of the institution;
 - (iii) income recognized by the institution from disposals of non-
trading investments of the institution;
 - (iv) litigation settlements in favour of the institution; and
 - (v) income recognized by the institution from insurance claims
for the benefit of the institution;

"note issuance and revolving underwriting facilities" () means any facility in respect of the issue of debt securities to the market where -

- (a) a borrower may draw down funds, up to a prescribed limit, over a pre-defined period, should any issue of the debt securities prove unable to be placed in the market; and
- (b) the unplaced amount is to be taken up, or funds made available, by the underwriter of the facility;

"notional amount" (), in relation to an off-balance sheet exposure of an authorized institution, means the reference amount used to calculate payment streams between the parties to the exposure;

"operational risk" (), in relation to an authorized institution, means the institution's operational risk as referred to in paragraph (c) of the definition of "capital adequacy ratio" in section 2(1) of the Ordinance;

"OTC derivative transaction" () -

- (a) subject to *paragraph (b)*, means an exchange rate contract, interest rate contract, equity contract or precious metal contract or other commodity contract;
- (b) does not include a contract referred to in *paragraph (a)* which is -
 - (i) traded on an exchange; and
 - (ii) subject to daily re-margining requirements;

"other commodity contract" () means a forward, swap, option or similar derivative contract the value of which is derived from the value of

commodities (including energy, agricultural assets, base metals and other non-precious metals);

"partly paid-up shares and securities" (), in relation to an authorized institution, means shares or securities the unpaid portion of which the institution may be called upon by the issuer to pay at a specified or unspecified date in the future;

"past due exposure" () means an exposure which -

- (a) is overdue for more than 90 days; or
- (b) has been rescheduled;

"positive current exposure" (), in relation to a transaction referred to in *paragraph (h) or (i)* of the definition of "cash items", means the risk of loss on the difference between -

- (a) the transaction valued at the agreed settlement price; and
- (b) the transaction valued at the current market price;

"potential exposure" (), in relation to an off-balance sheet exposure of an authorized institution which is an OTC derivative transaction or credit derivative contract, means the principal amount of the transaction or contract, as the case may be, multiplied by the applicable credit conversion factor;

"precious metal contract" () means a forward, swap, option or similar derivative contract the value of which is derived from the value of underlying precious metals (including silver, platinum and palladium);

"principal amount" () -

- (a) in relation to an on-balance sheet asset of an authorized institution, means the current book value (including accrued interest or revaluations) of the asset;
- (b) in relation to an off-balance sheet exposure of an authorized institution, means -
 - (i) subject to *subparagraph (ii)*, in the case of an exposure listed in *Table 1*, the contracted amount of the exposure;
 - (ii) in the case of an exposure listed in *Table 1* which is an undrawn or partially drawn facility, the amount of the undrawn commitment;
 - (iii) subject to *subparagraph (iv)*, in the case of an exposure listed in *Table 2*, the notional amount of the exposure;
 - (iv) in the case of an exposure listed in *Table 2* where the stated notional amount of the exposure is leveraged or enhanced by the structure of the exposure, the effective notional amount of the exposure taking into account that the stated notional amount is so leveraged or enhanced, as the case may be;

"prior consent" () means prior consent in writing;

"property-holding shell company" () means a company which does not trade or engage in any business activity except for the holding of residential properties;

"public sector entity" () means an entity -

- (a) specified in a notice under *Part 3 of Schedule 1A*; or
- (b) specified by a relevant banking supervisory authority (whether by means of legislation or a public notice or otherwise) to be a public sector entity for the purpose of applying preferential risk-weighting treatment under capital adequacy standards formulated in accordance with -
 - (i) the International Convergence of Capital Measurement and Capital Standards published, by the Basel Committee on Banking Supervision, in July 1988: or
 - (ii) the International Convergence of Capital Measurement and Capital Standards - A revised Framework published, by the Basel Committee on Banking Supervision, in June 2004;

"recognized collateral" () means collateral falling within *section 34*;

"recognized credit derivative contract" () means -

- (a) a credit derivative contract falling within *section 55(1)*;
- (b) a credit derivative contract falling within *section 55(2)* to the extent that it is deemed under that section to be a recognized credit derivative contract;

"recognized credit risk mitigation" (), in relation to the on-balance sheet assets or off-balance sheet exposures of an authorized institution, means the use by the institution of recognized collateral, recognized credit derivative contracts, recognized guarantees, or recognized netting, for the purpose of

reducing the risk-weighted amount of the on-balance sheet assets or off-balance sheet exposures, as the case may be, pursuant to these Rules;

"recognized exchange" () means a stock exchange specified in Part 3 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571);

"recognized guarantee" () means a guarantee falling within *section 54*;

"recognized netting" () means any netting done pursuant to a valid bilateral netting agreement;

"reference entity" (), in relation to a credit derivative contract, means the entity upon whose credit status that contract is based;

"reference obligation" (), in relation to a credit derivative contract, means the specified obligation –

- (a) of a specified reference entity in that contract; and
- (b) pursuant to which the basis of a cash settlement, or the seniority of deliverable obligations for physical settlements, is determined;

"relevant credit conversion factor" (), in relation to an off-balance sheet exposure referred to in *section 25*, means the credit conversion factor specified in *Part 3A of Schedule 1A* in respect of that exposure;

"relevant international organization" () means an international organization specified in *Part 4 of Schedule 1A*;

"relevant risk" (), in relation to an authorized institution, means the credit risk, operational risk or market risk of the institution;

"repo-style transaction" (), in relation to an authorized institution, means a transaction entered into by the institution whereby the institution -

- (a) agrees to sell securities to a third party for a sum of money with a commitment to repurchase the securities at an agreed price on an agreed future date from the third party;
- (b) lends securities to a third party and receives a sum of money or other securities from the third party in exchange as collateral;
- (c) agrees to acquire securities from a third party for a sum of money with a commitment to resell the securities at an agreed price on an agreed future date to the third party; or
- (d) borrows securities from a third party and provides a sum of money or other securities to the third party in exchange as collateral;

["residential mortgage loan" (), in relation to an authorized institution,

means a loan -

- (a) advanced by the institution to a borrower; and
- (b) secured on one or more than one residential property;]

"restricted collective investment scheme" () means a collective investment scheme specified in *Part 1 of Schedule 1A*;

"restricted foreign public sector entity" () means a foreign public sector entity specified in *Part 5 of Schedule 1A*;

"restricted jurisdiction" () means a jurisdiction specified in *Part 2 of Schedule 1A*;

"restricted securities regulator" () means a securities regulator specified in *Part 6 of Schedule 1A*;

"restricted sovereign" () means a sovereign specified in *Part 7* of *Schedule 1A*;

["risk-weighted" (), in relation to the calculation of a relevant risk of an authorized institution -

- (a) in the case of an on-balance sheet asset of the institution, means the measure of the institution's exposure to the relevant risk in respect of the asset as calculated in accordance with *Division 3* of *Part 4* in the case of credit risk;
- (b) in the case of an off-balance sheet exposure of the institution, means the measure of the institution's exposure to the relevant risk in respect of the exposure as calculated in accordance with *Division 4* of *Part 4* in the case of credit risk;]

"second-to-default credit derivative" () means a credit derivative contract under which -

- (a) the protection buyer obtains credit protection for a basket of reference [entities]; and
- (b) the second default among the reference [entities] triggers the credit protection and terminates the contract;

"securities firm" () -

- (a) means an entity -
 - (i) licensed and supervised by a relevant securities regulator pursuant to the law of a country other than Hong Kong; and

(ii) which is subject to supervisory arrangements regarding the maintenance of adequate capital to support its business activities comparable to those prescribed for authorized institutions under the Ordinance and these Rules; and

(b) includes a licensed corporation that has been granted a licence to carry on a regulated activity by the Securities and Futures Commission of Hong Kong;

"securities regulator" () does not include a restricted securities regulator;

"senior management" (), in relation to an authorized institution, includes the chief executives and managers of the institution;

"short-term ECAI issue specific rating" (), in relation to a debt obligation issued or undertaken by a bank, securities firm or corporate, means a short-term credit assessment rating assigned to the obligation by an ECAI;

["simple approach" (), in relation to collateral, means;]

"small business" (), in relation to the use by an authorized institution of the STC to calculate its credit risk -

(a) means -

(i) subject to *paragraph (b)*, an unlisted company with an annual turnover not exceeding \$50 million which has given its consent for the disclosure of its credit data to a commercial credit reference agency; or

(ii) an unincorporated enterprise with an annual turnover not exceeding \$50 million which has given its consent for disclosure of its credit data to a commercial credit reference agency;

(b) does not include an unlisted company belonging to a group of companies with an annual turnover in excess of \$50 million;

"sovereign" () means -

- (a) the Government;
- (b) the central government of a country;
- (c) the central bank of a country;
- (d) an authority of a country which performs in the country functions similar to the functions performed by the Monetary Authority in Hong Kong; or
- (e) a relevant international organization;

"sovereign foreign public sector entity" () -

- (a) subject to *paragraph (b)*, means a foreign public sector entity which is regarded as a sovereign for the purpose of calculating the capital adequacy ratio of a bank by the relevant banking supervisory authority of the jurisdiction in which the entity and the bank are incorporated or otherwise established;
- (b) does not include a restricted foreign public sector entity;

"specific provisions" (), in relation to an on-balance sheet asset or off-balance sheet exposure of an authorized institution, means -

- (a) an allowance for impairment loss of financial assets that are individually assessed for impairment in accordance with Hong Kong Accounting Standard 39; and
- (b) provisions made in accordance with Hong Kong Accounting Standard 37;

"standardized approach" () -

- (a) in relation to the calculation of an authorized institution's credit risk, means the method of calculating that risk set out in *Part [..]*;
- (b) in relation to the calculation of an authorized institution's operational risk, means the method of calculating that risk set out in *Division 2 of Part 5*;

"standardized business line" () means a business line specified in *section 64(a), (b), (c), (d), (e), (f), (g) or (h)* as read with *Schedule 4*;

"standard supervisory haircut" (), in relation to the comprehensive approach to the treatment of collateral, means a haircut specified in *Schedule 3*;

"STC" (), in relation to the calculation of an authorized institution's credit risk, means the standardized approach;

["STM" (), in relation to the calculation of an authorized institution's market risk, means the standardized approach;]

"STO" (), in relation to the calculation of an authorized institution's operational risk, means the standardized approach;

"Tier 2 country" () means any country which is not a Tier 1 country;

"title transfer" (), in relation to collateral, means an outright transfer of the legal and beneficial ownership in the collateral from the collateral provider to the collateral taker;

"total return swap" () means an agreement under which one party ("total return payer") transfers the total economic performance of a reference obligation to the other party ("total return receiver");

"trade-related contingency" () -

- (a) means a contingent liability which relates to trade-related obligations; and
- (b) includes liabilities arising from issuing and confirming letters of credit, acceptances on trade bills, and shipping guarantees;

"trading book" (), in relation to an authorized institution, means the institution's positions in financial instruments and commodities -

- (a) held -
 - (i) with the intention of trading in the financial instruments and commodities; or
 - (ii) for the purpose of hedging one or more than one of the positions; and
- (b) where -
 - (i) the positions are free of any restrictive covenants or are able to be completely hedged; and
 - (ii) the positions are frequently and accurately valued and actively managed;

"transaction-related contingency" (), in relation to an authorized institution -

- (a) means a contingent liability which involves an irrevocable obligation of the institution to pay a beneficiary when a customer fails to perform a contractual and non-financial obligation; and
- (b) includes a performance bond, bid bond, warranty and standby letter of credit related to a particular transaction;

"uncovered portion" () means the uncovered portion referred to in *section 36(1)(c)*;

["unrated" (), in relation to an exposure (howsoever described) of an authorized institution, means -

- (a) the exposure has never been assigned an ECAI issue specific rating; or
- (b) there is no current ECAI issue specific rating (including a current short-term ECAI issue specific rating) assigned to the exposure;]

["valid bilateral netting agreement" (), in relation to an authorized institution, means an agreement -

- (a) in writing;
- (b) that creates a single legal obligation for all individual contracts covered by the agreement, and provides, in effect, that the institution would have a single claim or obligation to receive or pay only the net amount of the sum of the positive and negative mark-to-market values of the individual contracts covered by the

agreement in the event that a counterparty to the agreement, or a counterparty to whom the agreement has been validly assigned, fails to comply with any obligation under the agreement due to default, insolvency, bankruptcy, or similar circumstance;

- (c) in respect of which the institution has been given legal advice in writing to the effect that in the event of a challenge in a court of law, including a challenge resulting from default, insolvency, bankruptcy, or similar circumstance, the relevant court or administrative authority would find the institution's exposure to be the net amount under -
- (i) the law of Hong Kong or, in the case of a subsidiary of the institution which is incorporated outside Hong Kong and which is included in the calculation of the capital adequacy ratio of the institution on a consolidated basis, the law of the jurisdiction in which the subsidiary is incorporated;
 - (ii) the law of the jurisdiction in which the counterparty is incorporated or the equivalent location in the case of non-corporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;
 - (iii) the law that governs the individual contracts covered by the agreement; and
 - (iv) the law that governs the agreement;

- (d) in respect of which the institution establishes and maintains procedures to monitor developments in any law relevant to the agreement and to ensure that the agreement continues to satisfy this definition;
- (e) in respect of which the institution manages the transactions covered by the agreement on a net basis;
- (f) in respect of which the institution maintains in its files documentation adequate to support the netting of the contracts covered by the agreement; and
- (g) that is not subject to a provision that permits the non-defaulting counterparty to make only limited payment, or no payment at all, to the defaulter or the estate of the defaulter, regardless of whether or not the defaulter is a net creditor under the agreement;]

"year" () -

- (a) in relation to the determination of an authorized institution's gross income; or
- (b) in relation to the determination of an authorized institution's –
 - (i) loans and advances in the retail banking business line; or
 - (ii) loans and advances in the commercial banking business line,

for the purposes of calculating of the institution's operational risk, means a period of 4 consecutive calendar quarters.

(2) Any reference in these Rules to a table or formula followed by a number is a reference to the table or formula, as the case may be, in these Rules bearing that number.

(3) Where under these Rules the prior consent of the Monetary Authority is required by an authorized institution in respect of any matter, the institution shall seek the prior consent by making an application in the specified form, if any, to the Monetary Authority.

(4) Where under a provision of these Rules the Monetary Authority is required to give notice of any matter to all authorized institutions incorporated in Hong Kong, or to a class of such institutions, it shall be sufficient compliance with that provision if the Monetary Authority publishes the notice in the Gazette.

(5) A reference in these Rules to a claim arising in respect of a guarantee (or words to the like effect) is a claim for the purposes of these Rules whether or not any event has occurred which may give rise to a right to sue pursuant to the guarantee.

PART 2

APPLICATION OF THESE RULES

[Not incorporated in this set]

PART 3

DETERMINATION OF CAPITAL BASE

[Not incorporated in this set]

PART 4

CALCULATION OF CREDIT RISK

Division 1 - Application

6. Application of *Part 4*

This Part shall apply to an authorized institution which uses the BSA to calculate its credit risk.

**Division 2 - Calculation of credit risk under BSA, assets and exposures to be covered
in calculation and categorisation of assets and exposures**

7. Basic approach to calculation of credit risk

(1) Subject to *subsection (2)*, an authorized institution shall calculate an amount (“relevant amount”) representing the degree of risk-weighted credit risk to which the institution is exposed by -

- (a) calculating the risk-weighted amount of the institution’s on-balance sheet assets by multiplying the principal amount of each such asset net of specific provisions by the asset’s relevant risk-weight;
- (b) calculating the risk-weighted amount of the institution’s off-balance sheet exposures by -
 - (i) converting the principal amount of each such exposure into its credit equivalent amount in the manner set out in *section 23* or *25*, as the case requires; and
 - (ii) multiplying the credit equivalent amount by the exposure’s relevant risk-weight after deducting, in the case of such an exposure which is an OTC derivative transaction or credit derivative contract, from that credit equivalent amount any specific provisions made in respect of such exposure; and
- (c) aggregating the figures derived under *paragraphs (a)* and *(b)* to arrive at the relevant amount.

(2) An authorized institution may, in calculating the relevant amount in relation to credit risk, reduce the risk-weighted amount of the institution's exposure in respect of an on-balance sheet asset or off-balance sheet exposure of the institution by taking into account the effect of any recognized credit risk mitigation in respect of the on-balance sheet asset or off-balance sheet exposure, as the case may be.

8. On-balance sheet assets and off-balance sheet exposures to be covered

An authorized institution shall take into account and risk-weight -

- (a) all of its on-balance sheet assets and off-balance sheet exposures booked in its banking book except such assets or exposures -
 - (i) which under *sections [..]* and *[..]* are required to be deducted from the institution's core or supplementary capital; or
 - (ii) subject to the requirements of *Part 7*; and
- (b) all of its credit exposures to counterparties under credit derivative contracts, OTC derivative transactions, or repo-style transactions, booked in its trading book.

9. Categorisation of on-balance sheet assets

An authorized institution shall classify each of its on-balance sheet assets into one only of the following categories –

- (a) cash items;
- (b) claims on sovereigns;
- (c) claims on public sector entities;
- (d) claims on multilateral development banks;
- (e) claims on banks;
- (f) residential mortgage loans; and
- (g) other assets.

**Division 3 – Calculation of risk-weighted amount of authorized institution’s
on-balance sheet assets**

9A. Cash items

An authorized institution shall allocate a risk-weight of 0% to all cash items except that -

- (a) in the case of cash items falling within *paragraph (d)* of the definition of “cash items”, the institution shall allocate a risk-weight that is the same as the risk-weight applicable to the other person who holds the gold bullion concerned in accordance with *sections 10, 12, 13, 14 and 20*;
- (b) in the case of cash items falling within *paragraph (e)* of the definition of “cash items”, the institution shall allocate a risk-weight of 100%;
- (c) in the case of cash items falling within *paragraph (f)* of the definition of “cash items”, the institution shall allocate a risk-weight of 20%; and
- (d) in the case of cash items falling within *paragraph (i)* of the definition of “cash items”, the institution shall allocate a risk-weight applicable to the counterparty of the transaction concerned in accordance with *sections 10, 12, 13, 14 and 20*.

10. Claims on sovereigns

(1) Subject to *section 11*, an authorized institution shall allocate a risk-weight of-

- (a) 0% to a claim by it on a sovereign of a Tier 1 country where the claim arises from a loan by the institution to that sovereign;
- (b) 0% to a claim by it on a sovereign of a Tier 2 country where –
 - (i) the claim arises from a loan by the institution to that sovereign; and
 - (ii) the claim is a domestic currency claim;
- (ba) 0% to a claim by it on a sovereign of a Tier 1 or Tier 2 country where the claim arises from a deposit payable on demand by the institution with that sovereign;
- (c) 10% to a claim by it on a sovereign of a Tier 1 country where the claim arises from –
 - (i) fixed interest securities with a residual maturity of less than one year –
 - (A) issued by that sovereign; and
 - (B) held by the institution; or
 - (ii) floating rate securities of any maturity –
 - (A) issued by that sovereign; and
 - (B) held by the institution;

- (d) 20% to a claim by it on a sovereign of a Tier 1 country where the claim arises from fixed interest securities with a residual maturity of not less than one year –
 - (i) issued by that sovereign; and
 - (ii) held by the institution;
- (e) 10% to a claim by it on a sovereign of a Tier 2 country where –
 - (i) the claim arises from –
 - (A) fixed interest securities with a residual maturity of less than one year –
 - (I) issued by that sovereign; and
 - (II) held by the institution; or
 - (B) floating rate securities of any maturity –
 - (I) issued by that sovereign; and
 - (II) held by the institution; and
 - (ii) the claim is a domestic currency claim;
- (f) 20% to a claim by it on a sovereign of a Tier 2 country where –
 - (i) the claim arises from fixed interest securities with a residual maturity of not less than one year –
 - (A) issued by that sovereign; and
 - (B) held by the institution; and
 - (ii) the claim is a domestic currency claim;
- (g) 10% to a claim by it arising in respect of a guarantee by a sovereign of a Tier 1 country of any –

- (i) fixed interest securities with a residual maturity of less than one year held by the institution; or
 - (ii) floating rate securities of any maturity held by the institution;
- (h) 20% to a claim by it arising in respect of a guarantee by a sovereign of a Tier 1 country of any fixed interest securities with a residual maturity of not less than one year held by the institution;
- (i) 10% to a claim by it –
 - (i) arising in respect of a guarantee by a sovereign of a Tier 2 country of any –
 - (A) fixed interest securities with a residual maturity of less than one year held by the institution; or
 - (B) floating rate securities of any maturity held by the institution;
 - (ii) where the securities are –
 - (A) denominated in the local currency of the Tier 2 country; and
 - (B) funded by liabilities entered into by the institution in that currency;
- (j) 20% to a claim by it -
 - (i) arising in respect of a guarantee by a sovereign of a Tier 2 country of any fixed interest securities with a residual maturity of not less than one year held by the institution;

- (ii) where the securities are -
 - (A) denominated in the local currency of the Tier 2 country; and
 - (B) funded by liabilities entered into by the institution in that currency; and
- (k) 100% to a claim by it on a sovereign of a Tier 2 country where the claim -
 - (i) is not a domestic currency claim; and
 - (ii) does not arise from a deposit payable on demand by the institution with that sovereign.

(2) For the avoidance of doubt, it is hereby declared that, for the purposes of this section, a claim by an authorized institution on the Government includes a claim by the institution on the Exchange Fund.

11. Exception to *section 10*

Where a claim on a sovereign by an authorized institution consists of a claim on a relevant international organization, then the institution shall allocate a risk-weight of 0% to the claim.

12. Claims on public sector entities

An authorized institution shall allocate a risk-weight of –

- (a) 20% to a claim by it on a public sector entity of a Tier 1 country;
- and
- (b) 100% to a claim by it on a public sector entity of a Tier 2 country.

13. Claims on multilateral development banks

An authorized institution shall allocate a risk-weight of 0% to a claim by it on a multilateral development bank.

14. Claims on banks

An authorized institution shall allocate a risk-weight of –

- (a) 20% to a claim by it on a bank falling within *paragraph (a)* of the definition of “bank”;
- (b) 20% to a claim by it on a bank falling within *paragraph (b)* of the definition of “bank” and which is incorporated or otherwise established in a Tier 1 country;
- (c) 20% to a claim, with a residual maturity of less than one year, by it on a bank falling within *paragraph (b)* of the definition of “bank” and which is incorporated or otherwise established in a Tier 2 country; and
- (d) 100% to a claim, with a residual maturity of not less than one year, by it on a bank falling within *paragraph (b)* of the definition of “bank” and which is incorporated or otherwise established in a Tier 2 country.

[15. Provision not used.]

[16. Provision not used.]

[17. **Provision not used.**]

[18. Provision not used.]

[19. Residential mortgage loans

(1) Subject to *subsections (2) and (3)*, an authorized institution shall allocate a risk-weight of 50% to a residential mortgage loan where -

- (a) the borrower under the loan is -
 - (i) an individual or individuals; or
 - (ii) a property-holding shell company;
- (b) the loan is secured by a first legal charge on a residential property or more than one residential property;
- (c) each residential property falling within *paragraph (b)* is -
 - (i) if *paragraph (a)(i)* is applicable, used as the residence of the borrower or as a residence of a tenant of the borrower;
 - (ii) if *paragraph (a)(ii)* is applicable, used as the residence of the directors or shareholders of the borrower or as a residence of a tenant of the borrower;
- (d) the loan-to-value ratio of the loan, if each residential property falling within *paragraph (b)* is situated in Hong Kong, does not exceed 90% at the time a commitment to extend the loan was created by the institution, or in relation to a residential mortgage loan purchased by the institution, at the time the loan was purchased; and
- (e) if the borrower under the loan is a property-holding shell company -

- (i) all of the borrowed-monies obligations of the company arising under the loan are the subject of a personal guarantee –
 - (A) entered into by one or more than one director or shareholder (“guarantor”) of the company; and
 - (B) that fully and effectively covers those obligations;
- (ii) the institution, having due regard to the guarantor’s financial obligations (including, in particular, all the guarantor’s borrowed-monies obligations and obligations of suretyship), is satisfied that the guarantor is able to discharge all the guarantor’s obligations under the guarantee; and
- (iii) the loan has been assessed by reference to substantially similar credit underwriting standards (including loan purpose and loan-to-value and debt service ratios) as would normally be applied by the institution to an individual.

(2) Where, in respect of a residential mortgage loan by an authorized institution, any residential property falling within *subsection (1)(b)* is situated outside Hong Kong, then the institution shall allocate a risk-weight to the loan generally provided for under the supervisory treatment, or capital adequacy requirements, applicable to banks carrying on banking business in the jurisdiction in which the residential property is situated.

(3) Subject to *subsection (4)*, an authorized institution shall exclude from the calculation of the loan-to-value ratio of a residential mortgage loan made or purchased by it any portion of the loan amount which has been provided by a property developer which is not a member of the group of companies of which the institution is a member.

(4) The Monetary Authority may, by notice in writing given to an authorized institution, direct the institution, in calculating -

- (a) the loan-to-value ratio of a residential mortgage loan specified in the notice; or
- (b) the loan-to-value ratio of a residential mortgage loan belonging to a class of residential mortgage loans specified in the notice,

to include a portion of the loan amount which would otherwise be excluded pursuant to *subsection (3)*.

(5) An authorized institution given a notice under *subsection (4)* shall comply with the notice.

(6) In this section -

“loan-to-value ratio” (), in relation to a residential mortgage loan, means the ratio of the amount outstanding under -

- (a) that loan; and
- (b) all other loans in respect of each residential property falling within *subsection (1)(b)* in respect of which the property is also used as security,

to the market value of the security.]

20. Other assets

- (1) This section applies to each on-balance sheet asset of an authorized institution which -
 - (a) does not fall within any of *sections 9A to 19* (including accrued interest if *subsection (5)* is applicable); and
 - (b) is not excluded for the purposes of this Part by *section 8(a)*.
- (2) Subject to *subsections (3) and (4)*, an authorized institution shall allocate a risk-weight of 100% to an asset to which this section applies.
- (3) The Monetary Authority may, by notice in writing given to an authorized institution, direct the institution to allocate to an asset, or an asset belonging to a class of assets, to which this section applies, a risk-weight specified in the notice, being a risk-weight greater than 100%.
- (4) An authorized institution given a notice under *subsection (3)* shall comply with the notice.
- (5) Where in respect of an on-balance sheet asset of an authorized institution, the institution has difficulty in allocating any accrued interest under the asset to the counterparties of the institution, then the institution may, with the prior consent of the Monetary Authority, treat the accrued interest as an asset to which this section applies.

[21. Provision not used.]

[22. Provision not used.]

[22A. Provision not used.]

**Division 4 – Calculation of risk-weighted amount of authorized institution’s off-
balance sheet exposures**

23. Off-balance sheet exposures

(1) An authorized institution, in calculating the risk-weighted amount of an off-balance sheet exposure of the institution -

- (a) specified in *column 1* of *Table 1*; and
- (b) booked in the institution’s banking book,

shall calculate the credit equivalent amount of the off-balance sheet exposure by multiplying the principal amount of the exposure, after deducting any specific provisions applicable to the exposure, by the credit conversion factor specified in *column 2* of *Table 1* opposite the exposure.

Table 1

**Determination of credit conversion factor for off-balance sheet exposures other than
OTC derivative transactions or credit derivative contracts**

Column 1	Column 2
Off-balance sheet exposures	Credit conversion factor
1. Direct credit substitutes	100%
2. Transaction-related contingencies	50%
3. Trade-related contingencies	20%
4. Asset sales with recourse	100%
5. Forward asset purchases	100%
6. Partly paid-up shares and securities	100%

Table 1 – continued

7.	Forward forward deposits placed	100%
8.	Note issuance and revolving underwriting facilities	50%
9.	<p>Other commitments under which the authorized institution is obliged to provide funds in the future not falling within any of the other categories of off-balance sheet exposures listed in this Table or <i>Table 2</i> -</p> <p>(a) commitments with an original maturity of up to and including one year;</p> <p>(b) commitments with an original maturity of over one year;</p> <p>(c) commitments which may be cancelled at any time unconditionally by the authorized institution or which provide for automatic cancellation due to a deterioration in a counterparty’s credit worthiness,</p> <p>where:</p> <p>“original maturity” (), in relation to an off-balance sheet exposure of an authorized institution, means the period between the date on which the exposure is entered into by the</p>	<p></p> <p>20%</p> <p>50%</p> <p>0%</p>

Table 1 - continued

institution and the earliest date on which the institution can, at its option, unconditionally cancel the exposure.	
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(2) Subject to *section 24*, an authorized institution, in calculating the risk-weighted amount of an off-balance sheet exposure of the institution -

(a) specified in *column 1* of *Table 2*; and

(b) booked in the institution's banking book or trading book,

shall calculate the credit equivalent amount of the off-balance sheet exposure -

(c) subject to *paragraph (d)* and to any exceptions specified in *column 1* of *Table 2* applicable to the off-balance exposure, by multiplying the principal amount of the off-balance sheet exposure by the credit conversion factor specified in *column 2* of *Table 2* opposite the off-balance sheet exposure and aggregating the resultant figure with the current exposure of the off-balance sheet exposure;

(d) subject to any exceptions specified in *column 1* of *Table 2* applicable to the relevant off-balance sheet exposure, if the relevant off-balance sheet exposure is a single currency floating rate against floating rate interest rate swap, by taking the current exposure of the relevant off-balance sheet exposure as the credit equivalent amount.

Table 2

Determination of credit conversion factor for OTC derivative transactions or credit derivative contracts

Column 1	Column 2
Off-balance sheet exposures	Credit conversion factor
<p>1. Exchange rate contracts (other than an excluded exchange rate contract) -</p> <ul style="list-style-type: none"> (a) with a residual maturity of up to and including one year; (b) with a residual maturity of over one year up to and including 5 years; (c) with a residual maturity of over 5 years, <p>where:</p> <p>“excluded exchange rate contract” () means –</p> <ul style="list-style-type: none"> (a) an exchange rate contract which has an original maturity of not more than 14 calendar days; or (b) a forward exchange rate contract entered into by the authorized institution pursuant to a swap deposit arrangement with a counterparty; 	<p>1%</p> <p>5%</p> <p>7.5%</p>

Table 2 - continued

<p>“swap deposit arrangement” (), means an arrangement entered into by the authorized institution with a counterparty whereby the institution sells foreign currency at spot rate to the counterparty against another currency, and at the same time, the counterparty deposits the foreign currency so purchased with the institution and enters into a forward exchange rate contract with the institution to sell the foreign currency so purchased back to the institution against another currency at a specified exchange rate on a future date.</p>	
<p>2. Interest rate contracts -</p> <p>(a) with a residual maturity of up to and including one year;</p> <p>(b) with a residual maturity of over one year up to and including 5 years;</p> <p>(c) with a residual maturity of over 5 years.</p>	<p>0%</p> <p>0.5%</p> <p>1.5%</p>

Table 2 - continued

3.	Equity contracts -	
(a)	with a residual maturity of up to and including one year;	6%
(b)	with a residual maturity of over one year up to and including 5 years;	8%
(c)	with a residual maturity of over 5 years.	10%
4.	Precious metal contracts -	
(a)	with a residual maturity of up to and including one year;	7%
(b)	with a residual maturity of over one year up to and including 5 years;	7%
(c)	with a residual maturity of over 5 years.	8%
5.	Other commodities contracts -	
(a)	with a residual maturity of up to and including one year;	10%
(b)	with a residual maturity of over one year up to and including 5 years;	12%
(c)	with a residual maturity of over 5 years.	15%

Table 2 - continued

<p>6. Credit derivative contracts consisting of -</p> <p>(a) credit default swaps booked in the trading book -</p> <p>(i) where the authorized institution is a protection buyer and the underlying reference [obligation] is -</p> <p>(A) a qualifying reference [obligation];</p> <p>(B) a non-qualifying reference [obligation];</p> <p>(ii) where the authorized institution is a protection seller and the credit default swap is subject to close-out upon the insolvency of the protection buyer while the underlying reference [entity] is still solvent and the underlying reference [obligation] is -</p> <p>(A) a qualifying reference [obligation];</p>	<p>5%</p> <p>10%</p> <p>5%</p>
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Table 2 - continued

<p>(B) a non-qualifying reference [obligation];</p> <p>(iii) where the authorized institution is a protection seller and the credit default swap does not fall within <i>subparagraph (ii)</i> and the underlying reference [obligation] is –</p> <p>(A) a qualifying reference [obligation];</p> <p>(B) a non-qualifying reference [obligation];</p> <p>(b) total return swaps booked in the trading book -</p> <p>(i) where the authorized institution is the total return receiver and the underlying reference [obligation] is -</p> <p>(A) a qualifying reference [obligation];</p> <p>(B) a non-qualifying reference [obligation];</p>	<p>10%</p> <p>0%</p> <p>0%</p> <p>5%</p> <p>10%</p>
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Table 2 - continued

<p>(ii) where the authorised institution is the total return payer and the underlying reference [obligation] is-</p> <p>(A) a qualifying reference [obligation];</p> <p>(B) a non-qualifying reference [obligation],</p> <p>where the amount of the potential exposure for a credit derivative contract falling within <i>paragraph (a)(ii)</i> shall be capped at the amount of the unpaid premium under the contract.</p>	<p>5%</p> <p>10%</p>
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24. Provisions supplementary to *section 23*

For the purposes of the operation of *section 23* in relation to an authorized institution and its off-balance sheet exposures -

- (a) in the case of an off-balance sheet exposure which has multiple exchanges of principal, the institution shall calculate its potential exposure to the off-balance sheet exposure by multiplying the product of the number of payments remaining to be made under the off-balance sheet exposure and the principal by the credit conversion factor required to be used under that section in respect of the off-balance sheet exposure;
- (b) in the case of an off-balance sheet exposure -
 - (i) structured to settle the outstanding exposures under the off-balance sheet exposure following specified payment dates; and
 - (ii) the terms of which are reset so that the market value of the off-balance sheet exposure is zero on the specified payment dates referred to in *subparagraph (i)*,
then the institution -
 - (iii) subject to *subparagraph (iv)*, shall treat the residual maturity of the off-balance sheet exposure as being equal to the period until the next reset date; and
 - (iv) if the off-balance sheet exposure is an interest rate contract where the remaining time to final maturity of the contract is

more than one year, shall not use a credit conversion factor of less than 0.5% in respect of the off-balance sheet exposure;

- (c) in the case of an off-balance sheet exposure booked in the institution's trading book which is a first-to-default credit derivative contract, the institution shall use the credit conversion factor of the non-qualifying reference [obligations] if there is at least one non-qualifying reference obligation in the basket of reference [entities], otherwise the credit conversion factor of the qualifying reference [obligations] is to be used;
- (d) in the case of an off-balance sheet exposure booked in the institution's trading book which is a second-to-default credit derivative contract or any other subsequent-to-default credit derivative contract, the institution shall -
 - (i) for the second-to-default credit derivative contract, use the credit conversion factor of the non-qualifying reference [obligations] if there are at least 2 non-qualifying reference [obligations] in the basket of reference [entities] of the second-to-default credit derivative contract, otherwise the credit conversion factor of the qualifying reference [obligations] is to be used;
 - [(ii) for the other subsequent-to-default credit derivative contract, determine the credit conversion factor of the other

subsequent-to-default credit derivative contract with
reference to the corresponding number of non-qualifying
reference [obligations] in the basket of reference [entities]
based on the approach taken in *subparagraph (i)*.]

25. Calculation of credit equivalent amount of other off-balance sheet exposures not specified in *Table 1* or *Table 2*

An authorized institution shall calculate the credit equivalent amount of an off-balance sheet exposure which is not specified in *Table 1* or *Table 2* by multiplying the principal amount of the exposure, after deducting any specific provisions applicable to the exposure -

- (a) subject to *paragraph (b)*, by a credit conversion factor of 100%;
- (b) by the relevant credit conversion factor applicable to the exposure.

26. Determination of risk-weights applicable to off-balance sheet exposures

(1) Subject to *subsection (2)*, an authorized institution shall determine the risk-weight applicable to an off-balance sheet exposure by reference to the risk-weight allocated to the counterparty to the exposure in accordance with *sections 9A to 20*.

(2) Where an off-balance sheet exposure referred to in *subsection (1)* of an authorized institution is -

- (a) an asset sale with recourse;
- (b) a forward asset purchase;
- (c) partly paid-up shares and securities; or
- (d) a direct credit substitute arising from the selling of credit derivative contracts in the form of total return swaps or credit default swaps in the institution's banking book,

then the institution shall determine the risk-weight applicable to the exposure -

- (e) in the case of *paragraph (a)* or *(b)*, by reference to the risk-weight allocated to the underlying assets or the issuer of the underlying assets of the exposure;
- (f) in the case of *paragraph (c)*, as 100%;
- (g) in the case of *paragraph (d)* and subject to *subsection (3)*, by reference to the risk-weight of the relevant reference [entity] in respect of the exposure.

(3) Where an off-balance sheet exposure referred to in *subsection (2)(d)* of an authorized institution is –

- (a) a first-to-default derivative contract, then the institution shall, for the purposes of that subsection, aggregate the risk-weights of the reference [entities] in the basket of reference entities specified in that contract up to a maximum of 1,250%;
- (b) a second-to-default credit derivative contract, then the institution shall, for the purposes of that subsection, aggregate the risk-weights of the reference [entities] in the basket of reference [entities] specified in that contract, but excluding the reference [entity] to which the lowest risk-weight would be allocated, up to a maximum of 1,250%;
- (c) any other subsequent-to-default credit derivative contract, then the institution shall, for the purposes of that subsection, and with all necessary modifications, apply *paragraph (b)* to that contract as that paragraph is applied to a second-to-default credit derivative contract so that the reference in that paragraph to “reference [entity] to which the lowest risk-weight would be allocated” is construed to mean “reference [entities] to which the lowest and second lowest risk-weights would be allocated” in the case of a third-to-default credit derivative contract and “reference [entities] to which the lowest, second lowest and third lowest risk-weights would be allocated” in the case of a fourth-to-default credit derivative contract and likewise for other subsequent-to-default credit derivative contracts;

- (d) a credit derivative contract which provides credit protection proportionately to the reference [entities] in the basket of reference [entities] as specified in the contract, then the institution shall calculate the risk-weight of its exposure under the contract by taking a weighted average of the risk-weights attributable to the reference [entities] in the basket by the use of *Formula 1A*.

Formula 1A

Calculation of risk-weight of credit derivative contract

falling within rule 26(3)(d)

$$RW_a = \sum_i a_i \times RW_i$$

where:

RW_a = average risk-weight in a basket of reference [entities];

a_i = proportion of credit protection allocated to a reference [entity]; and

RW_i = risk-weight of a reference [entity].

- (4) For the avoidance of doubt, it is hereby declared that where an off-balance sheet exposure referred to in *subsection (1)* of an authorized institution is a commitment to extend a residential mortgage loan, then the institution shall allocate a risk-weight in accordance with *section 19* to the exposure if the institution has no reason to believe that any of the provisions of that section will not be satisfied immediately after the loan that is the subject of that commitment is drawn down.

27. Calculation of total aggregate risk-weighted amount of credit exposure of authorized institution

An authorized institution shall calculate its total aggregate risk-weighted amount of credit exposure by adding together all of the products achieved -

- (a) by multiplying the principal amount of each of its on-balance sheet assets, after deducting any specific provisions applicable to the assets, by the risk-weights respectively allocated to the assets under *sections 9A to 20*; and
- (b) subject to *section 26(2)*, by multiplying the credit equivalent amount of each of its off-balance sheet exposures (after, in the case of those exposures listed in *Table 2*, deducting any specific provisions applicable to such exposures) by the risk-weights respectively allocated to the counterparties to the exposures under *sections 9A to 20*.

[28. Provision not used.]

29. Calculation of risk-weighted amount of repo-style transactions booked in banking book

An authorized institution shall calculate the risk-weighted amount of a repo-style transaction booked in its banking book by -

- (a) in the case of a repo-style transaction falling within *paragraph (a)* or *(b)* of the definition of “repo-style transaction”, treating the securities sold or lent under the transaction as an asset of the institution as if the institution had never entered into the transaction and, accordingly, calculating the risk-weighted amount of the transaction by reference to the risk-weight attributable to the securities;
- (b) in the case of a repo-style transaction falling within *paragraph (c)* of the definition of “repo-style transaction”, treating the money paid by the institution under the transaction as a loan to the counterparty secured on the securities which are provided to, or to the order of, the institution under the transaction and, accordingly, calculating the risk-weighted amount of the transaction by reference to the risk-weight attributable to the counterparty subject to the application of any recognized credit risk mitigation in respect of collateralized transactions;
- (c) in the case of a repo-style transaction falling within *paragraph (d)* of the definition of “repo-style transaction” -

- (i) if and to the extent the institution has provided collateral in the form of money under the transaction, treating the money paid by the institution under the transaction as a loan to the counterparty secured on the securities borrowed by the institution and, accordingly, calculating the risk-weighted amount of the transaction by reference to the risk-weight attributable to the counterparty subject to the application of any recognized credit risk mitigation in respect of collateralized transactions;
- (ii) if and to the extent the institution has provided collateral in the form of securities under the transaction, treating those securities as its asset as if the institution had never entered into the transaction and, accordingly, calculating the risk-weighted amount of the transaction by reference to the risk-weight attributable to the securities.

30. Calculation of risk-weighted amount of repo-style transactions booked in trading book

An authorized institution shall calculate the risk-weighted amount of a repo-style transaction booked in its trading book by -

- (a) reference to the market risk regime in any case where the transaction would fall within *section 29(a)* or *(c)(ii)* if it were booked in the institution's banking book;
- (b) the application of any recognized credit risk mitigation in respect of collateralized transactions in any case where the transaction would fall within *section 29(b)* or *(c)(i)* if it were booked in the institution's banking book.

[Division 5 – Division not used]

[31. Provision not used].

Division 6 – Use of collateral in credit risk mitigation

32. Credit risk mitigation in the form of collateral

Collateral is recognized for the purposes of calculating the risk-weighted amount of an authorized institution's on-balance sheet assets or off-balance sheet exposures where -

- (a) all documentation creating the collateral and providing for the obligations of the parties with respect to each other in respect of the collateral is binding on all the parties and legally enforceable in all the relevant jurisdictions;
- (b) the legal mechanism by which the collateral is pledged or transferred ensures that the institution has the right to liquidate, or to take legal possession of, the collateral in a timely manner in the event of a default by, or the insolvency or bankruptcy of, or other credit event applicable to any of –
 - (i) the counterparty; or
 - (ii) the custodian, if any, holding the collateral;
- (c) the institution has clear and adequate procedures for the timely liquidation of collateral in respect of an event referred to in *paragraph (b)*;
- (d) the institution has taken all steps to fulfil requirements under the law applicable to the institution's interest in the collateral which are necessary to obtain and maintain an enforceable security

- interest, whether by registration or otherwise, or to exercise a right to set-off in relation to title transfer collateral;
- (e) if the collateral is to be held by a custodian, the institution has taken reasonable steps to ensure that the custodian segregates the collateral from the custodian's assets;
 - (f) there is no material positive correlation between the credit quality of the counterparty in respect of which the institution has an exposure in respect of the on-balance sheet asset or off-balance sheet exposure, as the case may be, and the value of the collateral provided in respect of the exposure such that the value of the collateral would be likely to fall in the case of any material deterioration in the financial condition of the counterparty; and
 - (g) the collateral -
 - (i) is pledged for not less than the life of the exposure; and
 - (ii) is re-valued not less than every 6 months from the date upon which the collateral is taken in respect of the exposure.

[33. Provision not used.]

34. Recognized collateral which may be used for purposes of this Part

Only the following recognized collateral may be used by an authorized institution for the purposes of this Part -

- (a) cash on deposit with the institution or held at a third-party bank in a non-custodial arrangement;
- (b) certificates of deposit issued by the institution;
- [(c) paragraph not used;]
- (d) instruments issued by the institution which are comparable to instruments referred to in *paragraph (b)*;
- (e) debt securities issued or guaranteed by a sovereign of a Tier 1 country;
- (f) debt securities issued or guaranteed by a relevant international organization;
- (g) debt securities issued by a public sector entity of a Tier 1 country;
and
- (h) debt securities issued by a multilateral development bank.

[35. Provision not used.]

36. Calculation of risk-weighted amount taking into account credit risk mitigation effect of recognized collateral

(1) An authorized institution shall, in respect of an on-balance sheet asset or off-balance sheet exposure of the institution to which the recognized collateral relates -

- (a) subject to *paragraphs (b) and (c) and subsection (2)*, substitute the risk-weight of the collateral for the risk-weight of the counterparty for that proportion of the on-balance sheet asset or off-balance sheet exposure, as the case may be, that is equivalent to the value of the collateral (“credit protection covered portion”);
- (b) if the collateral consists of collateral -
 - (i) falling within *section 34(a), (b) or (d)*;
 - (ii) held at a third-party bank in a non-custodial arrangement;
and
 - (iii) unconditionally and irrevocably pledged or assigned to the institution,
substitute the risk-weight attributable to the third-party bank for the risk-weight of the counterparty for the credit protection covered portion;
- (c) allocate to that proportion of the on-balance sheet asset or off-balance sheet exposure (“uncovered portion”), as the case may be, which is not the credit protection covered portion, the risk-weight of the counterparty.

(2) An authorized institution shall, for the purposes of making a substitution pursuant to *subsection (1)(a)* or *(b)* where the underlying exposure and the collateral concerned are denominated in different currencies, reduce the value of the collateral by a standard haircut of 8%.

(3) An authorized institution shall determine the risk-weight to be allocated to recognized collateral in accordance with *sections 9A to 19*.

[37. Provision not used.]

38. Calculation of risk-weighted amount of on-balance sheet assets

An authorized institution shall calculate the risk-weighted amount of each of its on-balance sheet assets by -

- (a) dividing the principal amount of the asset, net of any specific provisions in respect of it, into -
 - (i) the credit protection covered portion; and
 - (ii) the uncovered portion;
- (b) multiplying the credit protection covered portion by the risk-weight allocated to the recognized collateral and multiplying the uncovered portion by the risk-weight attributable to the counterparty; and
- (c) adding together the 2 products derived from the application of *paragraph (b)*.

39. Calculation of risk-weighted amount of off-balance sheet exposures other than OTC derivative transactions

An authorized institution shall calculate the risk-weighted amount of each of its off-balance sheet exposures which is not an OTC derivative transaction by -

- (a) dividing the principal amount of the exposure, net of any specific provisions in respect of it, into -
 - (i) the credit protection covered portion; and
 - (ii) the uncovered portion;
- (b) multiplying the credit protection covered portion and the uncovered portion by the credit conversion factor applicable to the off-balance sheet exposure to produce 2 credit equivalent amounts;
- (c) multiplying the credit equivalent amount of the credit protection covered portion by the risk-weight attributable to the recognized collateral and multiplying the credit equivalent amount of the uncovered portion by the risk-weight attributable to the counterparty; and
- (d) adding together the 2 products derived from the application of *paragraph (c)*.

40. Calculation of risk-weighted amount of OTC derivative transactions

An authorized institution shall calculate the risk-weighted amount of each of its off-balance sheet exposures which is an OTC derivative transaction by -

- (a) multiplying the principal amount of the transaction by the applicable credit conversion factor to ascertain the potential exposure of the institution pursuant to the transaction and adding the current exposure of the institution in relation to the transaction to derive the credit equivalent amount of the transaction;
- (b) dividing the credit equivalent amount, net of any specific provisions in respect of the transaction, into the credit protection covered portion and the uncovered portion;
- (c) multiplying the credit equivalent amount of the credit protection covered portion by the risk-weight attributable to the recognized collateral and multiplying the credit equivalent amount of the uncovered portion by the risk-weight attributable to the counterparty; and
- (d) adding together the 2 products derived from the application of *paragraph (c)*.

[Division 7 – Division not used]

[41. Provision not used.]

[42. Provision not used.]

[43. Provision not used.]

[44. **Provision not used.**]

[45. Provision not used.]

[46. Provision not used.]

[47. Provision not used.]

[48. Provision not used.]

Division 8 – Use of netting in credit risk mitigation

49. On-balance sheet netting

(1) Where an authorized institution is entitled pursuant to a valid bilateral netting agreement to net amounts owed by the institution to a counterparty against amounts owed by the counterparty to the institution in respect of on-balance sheet assets of the institution, then the institution -

- (a) may take into account the effect of the netting in calculating its exposure to the counterparty; and
- (b) if a net credit exposure for the institution is the result of so taking into account the effect of the netting, shall use the net credit exposure in calculating the risk-weighted amount of the exposure.

(2) An authorized institution shall calculate its net credit exposure, if any, referred to in *subsection (1)(b)* by the use of *Formula 1*.

Formula 1

Calculation of net credit exposure under valid bilateral netting agreement

$$\text{Net credit exposure} = \max [0, \text{assets} - \text{liabilities} \times (1 - H_{fx})]$$

where:

assets = the amounts covered by the valid bilateral netting agreement owed by the counterparty to the authorized institution;

Formula 1 - continued

liabilities = the amounts covered by the valid bilateral netting agreement owed by the authorized institution to the counterparty; and

H_{fx} = the 8% haircut to be applied in consequence of a currency mismatch, if any, between the currencies in which the assets and liabilities are denominated.

(3) Where an authorized institution has a net credit exposure pursuant to a valid bilateral netting agreement, it shall calculate the risk-weighted amount of an on-balance sheet asset to which the net credit exposure relates by multiplying the net credit exposure by the risk-weight attributable to the counterparty.

50. Netting of OTC derivative transactions and netting of credit derivative contracts booked in trading book

(1) Where an authorized institution's exposure to a counterparty is under a nettable derivative transaction (and whether or not the valid bilateral netting agreement concerned relates to more than one type of nettable derivative transaction), then the institution may in accordance with *subsections (2) to (3)*, take into account the effect of the netting in calculating the risk-weighted amount of its exposure to the counterparty.

(2) Subject to *subsection (3)*, an authorized institution shall calculate the credit equivalent amount of a nettable derivative transaction by adding together –

- (a) the net current exposure (being the net amount of the sum of the positive and negative mark-to-market values of the individual nettable derivative transactions covered by the valid bilateral netting agreement concerned if the net amount is positive); and
- (b) the net potential exposure calculated by the use of *Formula 2*.

Formula 2

Calculation of net potential exposure under nettable derivative transactions

$$A_{\text{Net}} = 0.4 \times A_{\text{Gross}} + 0.6 \times \text{NGR} \times A_{\text{Gross}}$$

where:

A_{Net} = the net potential exposure;

A_{Gross} = the sum of the individual amounts derived by multiplying the principal amount of all of the individual nettable derivative transactions by the applicable credit conversion factor; and

NGR = the ratio of net replacement cost for the nettable derivative transactions (that is, the non-negative sums of positive and negative mark-to-market values of the transactions) to gross replacement cost for the nettable derivative transactions (that is, the sums of the transactions which have positive mark-to-market values).

(3) An authorized institution, in the application of *Formula 2* in respect of its nettable derivative transactions, shall calculate NGR by reference to the individual counterparty (“per counterparty basis”), or by reference to the counterparties in aggregate (“aggregate basis”), but not both.

(4) In this section -
“aggregate basis” (), in relation to NGR, means the ratio of total net replacement costs to total gross replacement costs for all nettable derivative transactions with individual counterparties;

“derivative transaction” () means –

- (a) an OTC derivative transaction; or
- (b) a credit derivative contract booked in the trading book;

“per counterparty basis” (), in relation to NGR, means the ratio of net replacement cost to gross replacement cost for the nettable derivative transactions with a particular counterparty.

[51. Provision not used.]

[52. Provision not used.]

**Division 9 - Use of guarantees and credit derivative contracts in
credit risk mitigation**

53. Application

An authorized institution may take into account the effect of recognized guarantees and recognized credit derivative contracts in calculating the risk-weighted amount of the institution's on-balance sheet assets and off-balance sheet exposures.

54. Recognized guarantees

A guarantee provided to an authorized institution is recognized if –

- (a) the guarantee is provided by –
 - (i) a sovereign of a Tier 1 country;
 - (ii) a sovereign of a Tier 2 country where the underlying exposures are –
 - (A) denominated in the local currency of that country;
and
 - (B) funded by liabilities entered into by the institution in that currency;
 - (iii) a relevant international organization;
 - (iv) a public sector entity of a Tier 1 country;
 - (v) a multilateral development bank;
 - (vi) a bank falling within *paragraph (a)* of the definition of “bank”;
 - (vii) a bank falling within *paragraph (b)* of the definition of “bank” and which is incorporated or otherwise established in a Tier 1 country; or
 - (viii) a bank falling within *paragraph (b)* of the definition of “bank” and which is incorporated or otherwise established in a Tier 2 country but only in respect of claims by the institution with a residual maturity of less than one year,

in each case having allocated to it a lower risk-weight than the obligor in respect of whose obligations to the institution the guarantee has been provided;

- (b) the guarantee gives the institution a direct claim against the guarantor;
- (c) the credit protection provided by the guarantee relates to a specific exposure, specific exposures, or specific pools of exposures, of the institution;
- (d) the undertaking of the guarantor to make payment in specified circumstances relating to the underlying exposure is clearly documented so that the extent of the credit protection provided by the guarantee is clearly defined;
- (e) there is no clause in the guarantee which would allow the guarantor to cancel the guarantee unilaterally or which would increase the effective cost of the credit protection offered by the guarantee as a result of the deteriorating credit quality of the underlying exposure except for a clause permitting termination in the event of a failure by the institution to pay sums due from it under the terms of the guarantee;
- (f) there is no clause in the guarantee that could operate to prevent the guarantor from being obliged to pay out promptly in the event that the obligor in respect of the underlying exposure to which the

guarantee relates defaults in making any payments due to the institution in respect of the exposure;

- (g) the country in which the guarantor is located and from which the guarantor may be obliged to make payment has no existing exchange controls in place or, if there are existing exchange controls in place, approval has been obtained for the funds to be remitted freely in the event that the guarantor is called upon under the terms of the guarantee to make payment to the institution;
- (h) the guarantor has no recourse to the institution for any losses suffered as a result of the guarantor being obliged to make any payment to the institution pursuant to the guarantee; and
- (i) the institution has the right to receive payments from the guarantor without first having to take legal action to pursue the obligor for payment.

55. Recognized credit derivative contracts

(1) A credit derivative contract entered into by an authorized institution as the protection buyer is recognized if –

- (a) the counterparty to the credit derivative contract (other than a contract which takes the form of an issue of cash-funded credit-linked notes by the institution) is–
 - (i) a sovereign of a Tier 1 country;
 - (ii) a sovereign of a Tier 2 country where the underlying exposures are –
 - (A) denominated in the local currency of that country;
 - and
 - (B) funded by liabilities entered into by the institution in that currency;
 - (iii) a relevant international organization;
 - (iv) a public sector entity of a Tier 1 country;
 - (v) a multilateral development bank;
 - (vi) a bank falling within *paragraph (a)* of the definition of “bank”;
 - (vii) a bank falling within *paragraph (b)* of the definition of “bank” and which is incorporated or otherwise established in a Tier 1 country; or
 - (viii) a bank falling within *paragraph (b)* of the definition of “bank” and which is incorporated or otherwise established

in a Tier 2 country but only in respect of claims by the institution with a residual maturity of less than one year, in each case having allocated to it a lower risk-weight than the obligor in respect of whose obligations to the institution the credit derivative contract has been entered into;

- (b) in the case of a credit derivative contract which is a credit default swap or total return swap (other than a restricted return swap), the economic benefit derived by the institution would make good the economic loss suffered by the institution in consequence of the default of the obligor in a manner substantially similar to that of a recognized guarantee;
- (c) the credit derivative contract gives the institution a direct claim against the protection seller;
- (d) the credit protection provided by the credit derivative contract relates to a specific exposure, specific exposures, or specific pools of exposures, of the institution;
- (e) the undertaking of the protection seller under the credit derivative contract to make payment in specified circumstances relating to the underlying exposure is clearly documented so that the extent of the credit protection provided by the credit derivative contract is clearly defined;
- (f) there is no clause in the credit derivative contract which would allow the protection seller to cancel the contract unilaterally or

which would increase the effective cost of the credit protection offered by the credit derivative contract as a result of the deteriorating credit quality of the underlying exposure except for a clause permitting termination in the event of a failure by the institution to pay sums due from it under the terms of the credit derivative contract;

- (g) there is no clause in the credit derivative contract that could operate to prevent the protection seller from being obliged to pay out promptly in the event that the obligor in respect of the underlying exposure to which the credit derivative contract relates defaults in making any payments due to the institution in respect of the exposure;
- (h) the country in which the protection seller is located and from which the protection seller may be obliged to make payment has no existing exchange controls in place or, if there are existing exchange controls in place, approval has been obtained for the funds to be remitted freely in the event that the protection seller is called upon under the terms of the credit derivative contract to make payment to the institution;
- (i) the protection seller has no recourse to the institution for any losses suffered as a result of the protection seller being obliged to make any payment to the institution pursuant to the credit derivative contract;

- (j) the credit derivative contract obliges the protection seller to make payment to the institution in the following credit events –
 - (i) any failure by the obligor in respect of the underlying exposure to pay amounts due under the terms of the underlying exposure (subject to any grace period in the contract which is of substantially similar duration to any grace period provided for in the terms of the underlying exposure);
 - (ii) the bankruptcy or insolvency of (or analogous events affecting) the obligor in respect of the underlying exposure or the obligor's failure or inability to pay its debts as they fall due or the obligor's admission in writing of the obligor's inability generally to pay its debts as they fall due;
or
 - (iii) subject to *subsection (2)*, the underlying exposure is restructured, involving forgiveness or postponement of payment of any principal or interest or fees, that results in the institution making a deduction or specific provision(s) or other similar debit to the institution's profit and loss account;
- (k) in any case where the underlying exposure provides a grace period within which the obligor may make good a default in payment, the

credit derivative contract is not capable of terminating prior to the expiry of the grace period;

- (l) in any case where the credit derivative contract provides for settlement in cash, it provides an adequate mechanism for valuation of the loss occasioned to the institution in respect of the underlying exposure and specifies a reasonable period within which that valuation is to be arrived at following a credit event;
- (m) in any case where the credit derivative contract has an underlying reference obligation (that is, the obligation used for the purposes of determining any cash settlement value, any deliverables or whether a credit event has occurred) that does not include or is different from the underlying exposure –
 - (i) the underlying reference obligation of the credit derivative contract ranks for payment or repayment *pari passu* with, or junior to, the underlying exposure; and
 - (ii) the obligor in respect of the underlying exposure is the same person as the obligor for the underlying reference obligation and legally enforceable cross default or cross acceleration clauses are included in the terms of both the underlying exposure and the underlying reference obligation;
- (n) in any case where under the terms of the credit derivative contract it is a condition of settlement that the institution transfers its rights

in respect of the underlying exposure to the protection seller, the terms of the underlying exposure provide that any consent that may be required from the obligor shall not be unreasonably withheld; and

- (o) the credit derivative contract specifies clearly the identity of the person who is empowered to determine whether a credit event has occurred, that person is not solely the protection seller and the institution is, under the terms of the underlying exposure, entitled to inform the protection seller of the occurrence of a credit event.

(2) Where any restructuring of the underlying exposure of a credit derivative contract does not, under the terms of the contract, require payment by the protection seller to the authorized institution concerned but –

- (a) the amount payable to the institution under the credit derivative contract is more than the underlying exposure, then the contract shall be deemed to be a recognized credit derivative contract to the extent of 60% of the underlying exposure; or
- (b) the amount payable to the institution under the credit derivative contract (“payable amount”) is less than, or equal to, the underlying exposure, then the contract shall be deemed to be a recognized credit derivative contract to the extent of 60% of the payable amount.

(3) In this section –

“restricted return swap” (), in relation to an authorized institution, means, a total

return swap where –

- (a) the institution is the total return receiver under the swap; and
- (b) the institution records the net payments received by it under the swap as net income but does not record, through deductions in fair value in the accounts of the institution or by an addition to reserves or provisions, the extent to which the value of the obligor’s obligations have deteriorated.

56. Capital treatment of guarantees and credit derivative contracts

(1) Subject to *subsections (2), (3) and (4)*, where an authorized institution's exposure to an on-balance sheet asset or off-balance sheet exposure of the institution is covered by a recognized guarantee or recognized credit derivative contract, then the institution may allocate to the on-balance sheet asset or off-balance sheet exposure, as the case may be, the risk-weight attributable to the guarantor or protection seller, as the case may be, instead of the risk-weight attributable to the counterparty.

(2) Subject to *subsections (3) and (4)*, where –

- (a) only part of an authorized institution's exposure (“covered portion”) to an on-balance sheet asset or off-balance sheet exposure of the institution is covered by a recognized guarantee or recognized credit derivative contract; and
- (b) the covered portion and the remainder of the exposure (“uncovered portion”) rank *pari passu*,

then the institution shall –

- (c) allocate to so much of the on-balance sheet asset or off-balance sheet exposure, as the case may be, as constitutes the covered portion, the risk-weight attributable to the guarantor or protection seller, as the case may be;
- (d) allocate to the remainder of the on-balance sheet asset or off-balance sheet exposure, as the case may be, as constitutes the uncovered portion the risk-weight attributable to the counterparty.

(3) Where a guarantor referred to in *subsection (1)* is a sovereign, then, for the purposes of that subsection, the risk-weight attributable to the guarantor shall be that attributable under *paragraph (a), (b) or (k)*, as the case requires, of *section 10(1)*.

(4) *Sections 38, 39 and 40* shall, with all necessary modifications, be used by an authorized institution to calculate the risk-weighted amount under *subsection (1)* or *(2)(c)*.

(5) Where under a recognized guarantee or recognized credit derivative contract there may be a currency mismatch, then, to the extent that a calculation required by *subsection (4)* by an authorized institution relates to that guarantee or contract, as the case may be, the institution shall reduce the covered portion by a standard haircut of 8%.

57. Credit derivative contracts which are credit default swaps or total return swaps

(1) Where the credit protection in respect of an authorized institution's underlying exposure consists of a recognized credit derivative contract which is a credit default swap or total return swap, then –

- (a) if upon the happening of a credit event the protection seller is obliged to pay the principal amount specified in the credit derivative contract to the institution in exchange for delivery by the institution of deliverable obligations of the same principal amount, then the institution may treat the underlying exposure as being fully covered;
- (b) if upon the happening of a credit event the protection seller is obliged to pay the principal amount specified in the credit derivative contract to the institution less the market value of the underlying reference obligation, calculated by specified calculation agents at some specified point in time after the credit event has occurred, then the institution may treat the underlying exposure as being fully covered; and
- (c) if upon the happening of a credit event the protection seller is obliged to pay a fixed amount to the institution, then the institution may only treat that amount of the underlying exposure that is equivalent to the fixed amount as being fully covered.

[(2) Provision not used.]

(3) Where the credit protection in respect of an authorized institution's underlying exposure consists of a recognized credit derivative contract which provides that, upon the happening of a credit event, the protection seller is not obliged to make a payment in respect of any loss –

(a) until the loss exceeds a specified amount (“first loss portion”); and

(b) except to the extent that the loss exceeds the first loss portion,

then the institution shall, in calculating its capital adequacy ratio, deduct the first loss portion from its capital base.

(4) Where the credit protection in respect of an authorized institution's underlying exposure consists of a recognized first-to-default credit derivative contract, then –

(a) the institution shall only recognize that credit protection, in respect of the basket of reference [entities] specified in the credit derivative contract, in relation to the reference [entity] which carries the lowest risk-weighted amount amongst the exposures to all the reference [entities] in the relevant basket if, and only if, the principal amount of the exposure to that reference entity is not more than the notional amount of the credit derivative contract; and

(b) accordingly, in the case of such credit protection so recognized, the institution may substitute the risk-weight of the protection seller for the risk-weight of the reference entity which carries the lowest risk-weighted amount within the basket.

(5) Where the credit protection in respect of an authorized institution's underlying exposure consists of a recognized second-to-default credit derivative contract, then the institution may, in respect of so much of that exposure as is covered by the credit protection, substitute the risk-weight of the protection seller for the risk-weight of the reference [entity] which carries the second lowest risk-weighted amount amongst the exposures to all reference [entities] in the basket of references [entities] specified in the contract ("relevant basket") only if –

- (a) the institution has, as a protection buyer, entered into a recognized first-to-default credit derivative contract in respect of which the basket of reference [entities] specified in the contract is the same as the relevant basket; or
- (b) a reference [entity] in the relevant basket has defaulted.

(5A) Where the credit protection in respect of an authorized institution's underlying exposure consists of a recognized subsequent-to-default credit derivative contract, then the institution may, with all necessary modifications, apply *subsection (5)* to that contract as that subsection is applied to a second-to-default credit derivative contract so that –

- (a) the reference to "a recognized first-to-default credit derivative contract in respect of which the basket of reference [entities] specified in the contract" in *paragraph (a)* of that subsection is construed to mean "recognized first-to-default and second-to-default credit derivative contracts in respect of which the basket of reference [entities] specified in each contract"; and

- (b) the reference to "a reference [entity] in the relevant basket has" in *paragraph (b)* of that subsection is construed to mean "2 reference [entities] in the relevant basket have",

in the case of a third-to-default credit derivative contract and likewise for other subsequent-to-default credit derivative contracts.

(6) Where the credit protection in respect of an authorized institution's underlying exposure is a credit derivative contract which provides credit protection proportionately to reference [entities] in the basket of reference [entities] as specified in the contract, then the institution shall calculate the risk-weighted amount of its exposure by substituting the risk-weight of the protection seller for the risk-weights of the reference [entities] to the extent of the amounts protected in respect of the reference [entities].

(7) Where the credit protection in respect of an authorized institution's underlying exposure takes the form of an issue of cash-funded credit-linked notes by the institution, then the institution –

- (a) may only treat that amount of the underlying exposure that is equivalent to the cash funding received from the notes as being fully covered; and
- (b) shall treat the covered portion of the underlying exposure as an exposure collateralized by cash deposit.

Division 10 – Multiple recognized credit risk mitigation and maturity mismatches

58. Multiple recognized credit risk mitigation

(1) Where in respect of a single exposure of an authorized institution to a counterparty –

- (a) 2 or more forms of recognized credit risk mitigation have been used by the institution; or
- (b) there is an overlap of coverage between 2 or more forms of recognized credit risk mitigation used by the institution,

then -

- (c) in the case of *paragraph (a)*, the institution shall calculate the risk-weighted amount of the exposure in accordance with these Rules by dividing the exposure into the portions that respectively represent the proportions of the exposure covered by each of the forms of credit risk mitigation so used;
- (d) in the case of *paragraph (b)*, the institution may select, in respect of the portion of the exposure covered by the overlap, the credit risk mitigation that will result in the lowest risk-weighted amount.

(2) Where an authorized institution has an exposure to a counterparty in the form of a general banking facility consisting of 2 or more credit lines, then –

- (a) the institution may, in calculating its risk-weighted amount in respect of the credit lines, allocate any credit protection taken in

respect of the exposure amongst the individual exposures under each of the credit lines; and

- (b) if the institution exercises its discretion under *paragraph (a)*, the institution shall aggregate the risk-weighted amounts to determine the total risk-weighted amount in respect of the general banking facility.

59. Maturity mismatches

(1) Where the credit protection provided in respect of an underlying exposure of an authorized institution has a residual maturity which is shorter than the residual maturity of the underlying exposure (“maturity mismatch”), then the institution shall not use the credit risk mitigation effect of that credit protection for the purposes of this Part.

(2) For the purposes of calculating the respective maturities of an exposure of an authorized institution and any credit protection covering the exposure, the institution shall –

- (a) if the credit protection is in the form of recognized collateral, guarantees or credit derivative contracts –
 - (i) adopt a conservative approach;
 - (ii) at any time before the obligor in respect of the underlying exposure performs the obligor’s obligations, take the effective maturity of the underlying exposure to be the longest possible remaining time after taking into account any applicable grace period provided for in the terms of the underlying exposure;
- (b) if the terms of the credit protection provide for an option which may reduce the term of that credit protection, take into account the option and the earliest possible date upon which it may be exercised;
- (c) if the terms of the credit protection provide that the protection seller may terminate the credit protection before its maturity, take

the maturity of the credit protection to be the first date upon which the protection seller may so terminate the credit protection; and

- (d) if the terms of the credit protection permit the institution to terminate the credit protection before its maturity and there is a positive incentive for the institution to exercise its discretion so to do, take the maturity of the credit protection to be the time left to run before the earliest date upon which the institution may exercise the discretion.

(3) For the purposes of this section, the residual maturity of credit protection which is recognized collateral falling within *section 34(a)* shall be taken to be the period for which it will continue to fulfil the requirements of *section 32* applicable to the credit protection.

PART 5

CALCULATION OF OPERATIONAL RISK

[NOT INCLUDED IN THIS SET]

PART 6

CALCULATION OF MARKET RISK

(This Part is temporarily vacant)

PART 7

ASSET SECURITISATION

(This Part is temporarily vacant)

SCHEDULE 1

**MINIMUM CRITERIA FOR APPROVAL UNDER *SECTION 5* OF THESE RULES TO USE STO OR
ASA TO CALCULATE OPERATIONAL RISK OF AUTHORIZED INSTITUTION**

[NOT INCLUDED IN THIS SET]

SCHEDULE 1A

SPECIFICATIONS FOR PURPOSES OF CERTAIN DEFINITIONS IN *SECTION 2(1)* OF THESE

RULES

[NOT INCLUDED IN THIS SET]

SCHEDULE 2

UNIFORM CREDIT QUALITY GRADES

[Not included in this set]

SCHEDULE 3

**STANDARD SUPERVISORY HAIRCUTS FOR
COMPREHENSIVE APPROACH TO TREATMENT OF COLLATERAL
[NOT INCLUDED IN THIS SET]**

SCHEDULE 4

**DETAILED DEFINITION OF EACH STANDARDIZED BUSINESS LINE
[NOT INCLUDED IN THIS SET]**

Dated this day of 2006.

Monetary Authority

Explanatory Note

1. These Rules are made under section 98A of the Banking Ordinance (Cap. 155) (as amended by the Banking (Amendment) Ordinance 2005) and prescribe the manner in which authorized institutions incorporated in Hong Kong shall calculate their capital adequacy ratio under section 98 of the Banking Ordinance. (See the definition of "capital adequacy ratio" inserted into section 2(1) of the Banking Ordinance by section 1 of Part 1 of the Schedule to the Banking (Amendment) Ordinance 2005).

Part 1 - Preliminary

2. *Section 1* specifies that the Rules shall come into operation on a day to be appointed by the Secretary for Financial Services and the Treasury.

3. *Section 2(1)* defines the terms used in the Rules. The definitions of "credit risk", "market risk" and "operational risk" should, in particular, be noted, because they cross-reference to the 3 kinds of risk specified in the definition of "capital adequacy ratio" as the risks to be taken into account in calculating an authorized institution's capital adequacy ratio. The Rules, in essence, consist of provisions setting out various approaches which may be adopted by authorized institutions to calculate those risks and other provisions which enable or assist any such calculation. It should also be noted that a number of acronyms are used as shorthand to describe the various approaches. (For

example, "STO" means the standardized approach to the calculation of an authorized institution's operational risk).

Part 2 - Application of these Rules

[Not included in this set]

Part 3 - Determination of Capital Base

5. Not included in this set.

Part 4 - Calculation of Credit Risk

Division 1 - Application

6. *Section 6* specifies that *Part 4* applies to authorized institutions which use the basic approach to calculate their credit risk.

***Division 2 - Calculation of credit risk under BSA, assets and exposures to be covered
in calculation and categorisation of assets and exposures***

7. *Section 7* specifies how an authorized institution shall calculate its credit risk under the basic approach and *section 8* specifies the on-balance sheet assets and off-balance sheet exposures of the institution which are required to be taken into account for the purposes of any such calculation. *Section 7* also specifies that an authorized institution may take into account the effect of any recognized credit risk mitigation for the purposes of calculating the risk-weighted amount in respect of the institution's on-balance sheet assets and off-balance sheet exposures. (See the definition of "recognized credit risk mitigation" in *section 2(1)* as read with the definitions of "credit protection", "nettable", "recognized collateral", "recognized credit derivative contract", "recognized guarantee", "recognized netting" and "valid bilateral netting agreement" in that section). *Section 9* requires an authorized institution to classify each of its on-balance sheet assets into one only of the categories specified in that section (for example, cash items, claims on sovereigns and residential mortgage loans).

**Division 3 - Calculation of risk-weighted amount of authorized institution's on-
balance sheet assets**

8. *Division 3* relates to *paragraph (a)* of *section 7(1)*. The assets falling within *section 8* are risk-weighted (by reference to the categories set out in *section 9*) as specified in *sections 9A* to *20*.

**Division 4 - Calculation of risk-weighted amount of authorized institution's off-
balance sheet exposures**

9. *Division 4* relates to *paragraph (b)* of *section 7(1)*. An authorized institution is required to calculate the credit equivalent amount (see the definition of "credit equivalent amount" in *section 2 (1)*) of its off-balance sheet exposures in accordance with *sections 23, 24* and *25* and to determine the risk-weights of those exposures in accordance with *section 26*. *Section 27* then specifies how the institution calculates its total aggregate risk-weighted amount of credit exposure using those credit equivalent amounts and risk-weights. *Sections 29* and *30* specify how an authorized institution shall calculate the risk-weighted amount of a repo-style transaction (see the definition of "repo-style transaction" in *section 2(1)*) booked in its banking book or trading book (see the definitions of "banking book" and "trading book" in *section 2(1)*).

Division 6 - Use of collateral in credit risk mitigation

10. *Section 32* specifies the collateral which is recognized for the purposes of calculating the risk-weighted amount of an authorized institution's on-balance sheet assets or off-balance sheet exposures. *Section 34* specifies the recognized collateral which may be used for the purposes of *Part 4*. *Section 36* specifies how an authorized institution shall calculate the risk-weighted amount taking into account the credit risk mitigation effect of recognized collateral. *Section 38* specifies how an authorized institution shall calculate the risk-weighted amount of each of its on-balance sheet assets having regard to the portions of the assets concerned which have or do not have credit protection. Similarly, *sections 39* and *40* specify how an authorized institution shall calculate the risk-weighted amount of each of its off-balance sheet exposures having regard to the extent to which they have credit protection.

[Division 7 – Division not used]

[11]. Paragraph not used]

Division 8 - Use of netting in credit risk mitigation

12. *Division 8* specifies the circumstances in which, and how, an authorized institution may take account of the effect of valid bilateral netting agreements in respect of calculating the risk-weighted amount of its exposures to the counterparties under the agreements.

Division 9 - Use of guarantees and credit derivative contracts in credit risk mitigation

13. *Division 9* specifies the guarantees (*section 54*) and credit derivative contracts (*section 55*) that are recognized for the purposes of taking into account the effect of credit risk mitigation in calculating the risk-weighted amounts of an authorized institution's on-balance sheet assets and off-balance sheet exposures. *Section 56* specifies that if an authorized institution's exposure to an on-balance sheet asset or off-balance sheet exposure is covered by a recognized guarantee or recognized credit derivative contract,

then the institution may allocate the guarantor's or protection seller's risk-weight to the on-balance sheet asset or off-balance sheet exposure. *Section 57* contains special provisions in respect of credit protection consisting of recognized credit derivative contracts which are credit default swaps or total return swaps. (See the definitions of "credit default swap" and "total return swap" in *section 2(1)*).

Division 10 - Multiple recognized credit risk mitigation and maturity mismatches

14. *Section 58* specifies what an authorized institution must do where an exposure of the institution has 2 or more distinct or overlapping forms of recognized credit risk mitigation in respect of a single exposure of the institution to a counterparty. *Section 59* specifies that if the credit protection provided in respect of an underlying exposure of an authorized institution has a residual maturity which is shorter than the residual maturity of the underlying exposure, then the institution shall not use the credit risk mitigation effect of the credit protection for the purposes of *Part 4*.

Part 5 - Calculation of Operational Risk

[Not included in this set]

Part 6 - Calculation of Market Risk

19. This Part is temporarily vacant.

Part 7 - Asset Securitisation

20. This Part is temporarily vacant.