HONG KONG MONETARY AUTHORITY
香港金融管理局

Our Ref : S4/3C
B1/15C
B1/21C

28 December 2012

The Chief Executive
All locally incorporated authorized institutions

Dear Sir / Madam,

Supervisory Policy Manual (SPM) – CA-G-5 "Supervisory Review Process" (Revised)

I am writing to inform you that, following consultation with the two industry Associations, the Monetary Authority (MA) is issuing by notice in the gazette today a revised version of the SPM module "Supervisory Review Process" as a statutory guideline under section 16(10) of the Banking Ordinance.

The main purposes of the revised module are to reflect changes to the Pillar 2 framework necessitated by the implementation of the Basel III capital standards in Hong Kong through amendment of the Banking Ordinance and Banking (Capital) Rules from 1 January 2013, and to explain how the revised Pillar 2 framework will operate in the context of the new risk-weighted capital ratios and capital buffers under Basel III. Further guidance is also provided in the revised module to enhance the assessment of risk factors relating to securitization risk and off-balance sheet exposures, counterparty credit risk, and high cost credit protection transactions, having regard to relevant guidance issued by the Basel Committee.

Key elements of revised framework

Under the revised Pillar 2 framework, the basic concept and principles presently underlying the supervisory review process (SRP) will be retained and the Pillar 2 capital add-on will continue to form a constituent part of an AI's minimum capital requirements to ensure that sufficient capital is held by AIs against both Pillar 1 risks (viz. credit, market and operational risks) and Pillar 2 risks (i.e. other risks not covered, or not adequately covered, under Pillar 1). However, the assessment framework under the SRP will be adjusted to address any potential overlap between Pillar 2 capital and the Basel III buffer capital when the latter comes into effect on 1 January 2016. (The industry will be consulted in due course on proposed amendments to the Banking (Capital) Rules to introduce the Basel III capital conservation and countercyclical buffer frameworks.)

The key revisions to the Pillar 2 framework set out in CA-G-5 can be summarised as follows:

(i) Determination of section 97F minimum CAR (re subsection 3.5 of the revised module): AIs will be required, from 1 January 2013, to comply with three minimum risk-weighted capital ratios, viz. the CET1 capital ratio, Tier 1 capital ratio and Total capital ratio, as prescribed in the new sections 3A and 3B of the Banking (Capital) Rules. These three ratios are collectively referred to as the "BCR minimum CAR" in the revised module. The MA may vary the BCR minimum CAR of individual AIs under the new section 97F of the Banking Ordinance, having regard to the risks associated with the AIs. The SRP will assist in identifying these risks. The BCR minimum CAR so varied is referred to as the "section 97F minimum CAR" in the revised module.

The section 97F minimum CAR of individual AIs will be determined by apportioning an AI's Pillar 2 capital requirement[1] to the three ratios underlying the BCR minimum CAR according to the Pillar 1 split in force during the specified period, i.e. –

- at any time during 2013, the split of 3.5 / 4.5 / 8[2];
- at any time during 2014, the split of 4 / 5.5 / 8; and
- at any time during 2015, the split of 4.5 / 6 / 8.

This apportionment method will ensure that the minimum Pillar 2 capital required to be held by AIs will at least be as loss-absorbing as their minimum Pillar 1 capital.

From 2016 onwards, the Pillar 2 capital requirement used for determining AIs' section 97F minimum CAR will be adjusted to remove the effect of any overlap with the Basel III capital buffers before applying the Pillar 1 split of 4.5 / 6 / 8 (see item (iii) below).

(ii) Restructuring of Pillar 2 capital requirement (re subsection 2.3 of the revised module): To address the issue of potential overlap with the capital buffers, the Pillar 2 capital requirement (P2) will be restructured into two constituent parts when the buffers are implemented from 1 January 2016:

- P2A, i.e. the portion of the Pillar 2 capital requirement that reflects risks not captured, or not adequately captured, in Pillar 1[3]. Under the SRP, P2A will be derived from assessment factors that relate to an AI's inherent risks as well as its underlying systems and controls and corporate governance arrangements for mitigating such risks, and hence does not constitute any overlap with the capital buffers. P2A will be treated in the same way as the capital held against Pillar 1 risks and will be a constituent part of an AI's section 97F minimum CAR; and

- P2B, i.e. the portion of the Pillar 2 capital requirement that is intended to provide a cushion of capital to bolster resilience in times of stress (and hence should be usable in such times) and that is not directly associated with P2A risks. Under the SRP,

---

[1] The Pillar 2 capital requirement refers to the capital requirement an AI is required to maintain in respect of its Pillar 2 risks, as derived from the SRP. This capital requirement will form the basis for determining the AI's section 97F minimum CAR.

[2] For example, if an AI's Pillar 2 capital requirement is 2%, its minimum CET1 capital ratio, Tier 1 capital ratio and Total capital ratio are respectively 4.375% (3.5%+2%*3.5/8), 5.625% (4.5%+2%*4.5/8), and 10% (8%+2%*8/8).

[3] Such risks are similar to the eight inherent risks identified by the HKMA for the purposes of its risk-based supervision (viz. credit, market, interest rate, liquidity, operational, legal, reputation, and strategic risks).

P2B will be derived from all factors assessed under "Capital Adequacy Assessment Process (CAAP)" (SRP scorecard C1) and certain factors assessed under "Capital Strength and Capability to Withstand Risk" (SRP scorecard C2) (see para. 3.4.6 of the revised module for more details). P2B can therefore be regarded as akin in nature to, and hence as having a degree of overlap with, the Basel III capital buffers.[4] To ensure its ongoing loss absorbency, P2B should be constituted solely by CETI capital.

To facilitate AIs' capital planning, we will, in advance of the restructuring of the Pillar 2 capital requirement coming into effect in 2016 (say, in the latter part of 2014), inform individual AIs of their P2A / P2B split.

(iii) Methodology for addressing overlap (re subsection 3.4 of the revised module): Starting from 1 January 2016, only P2A will form a constituent part of an AI's ongoing minimum capital requirements, and be allocated to the BCR minimum CAR according to the 4.5 / 6 / 8 split to arrive at a section 97F minimum CAR. P2B will be absorbed into the Basel III capital buffers (to the extent that P2B does not exceed the buffers) and require no additional capital. If the level of an AI's P2B exceeds the level of the Basel III capital buffers in force at a given time (such occasions should be rare), the AI should top up the buffers to the P2B level. See paras. 3.4.12 to 3.4.15 of the revised module for an illustration of the methodology.

(iv) Positioning of Pillar 2 under capital hierarchy (re subsection 2.3 of the revised module): For ease of reference, the capital hierarchy applicable to AIs from 2013 onwards is presented in the following table, which illustrates the positioning of Pillar 2, as a constituent part of an AI's ongoing minimum capital requirements, within the hierarchy:

Building block	**Components**	**Remarks**
Section 97F minimum CAR	• CET1 capital ratio (BCR minimum CAR + apportioned P2) • Tier 1 capital ratio (BCR minimum CAR + apportioned P2) • Total capital ratio (BCR minimum CAR + apportioned P2)	• All ratios must be met at all times • From 2016 onwards, P2 will be replaced by P2A when determining the capital add-on for the three ratios
Capital buffers (to be implemented from 1 January 2016 through amendment of Banking (Capital) Rules)	• Capital conservation buffer (in CET1 capital) • Countercyclical capital buffer (in CET1 capital) (whenever it is triggered)	• Falling below the buffer levels will render AIs subject to restrictions (e.g. reducing distribution of earnings) • From 2016 onwards, P2B (in CET1 capital)

[4] Despite the overlap, these assessment factors will remain within the SRP as they serve to differentiate individual AIs' performance for assessing and monitoring overall capital adequacy, so that supervisory measures can be taken where appropriate.

		will form a part of, and in effect be absorbed into, the buffers

(v) Formalisation of MA's procedures for varying AIs' BCR minimum CAR (re subsection 2.8 of the revised module): From 1 January 2013, the procedures for the MA to vary the BCR minimum CAR of individual AIs will be formalised pursuant to the new section 97F of the Banking Ordinance. In varying an AI's BCR minimum CAR, the MA should be satisfied, on reasonable grounds, that it is prudent to make the variation, taking into account the risks associated with the AI. The MA is also required to (a) send a draft notice to the AI specifying the proposed variation and the grounds for such variation; (b) give the AI 14 days (or any longer period as the MA may allow in any particular case) to make written representations; and (c) take into account such representations in finalising his decision. If an AI is aggrieved by the MA's decision to vary its BCR minimum CAR, the AI may make an application to the Banking Review Tribunal for review of the MA's decision under section 101B of the Ordinance. However, the making of an application to the Tribunal does not operate to suspend the MA's decision. These formalised procedures, as well as the mechanism for making representations and appeals by AIs, provide a set of checks and balances for the exercise by the MA of his power to vary an AI's BCR minimum CAR.

(vi) Removal of upper limit for setting AIs' minimum capital ratios (re subsection 3.3 of the revised module): The new section 97F of the Banking Ordinance sets no upper limit for the variation of an individual AI's BCR minimum CAR. Nevertheless, the MA will continue to calibrate the Pillar 2 capital requirement under the SRP based on a maximum of 8%, which is considered appropriate in the light of past experience. The MA will, however, review the calibration from time to time to ensure that it remains suitable for the local banking sector. The MA also retains the right to impose a higher Pillar 2 capital requirement on a particular AI if this should be justified by the SRP results.[5]

(vii) Non-statutory trigger ratios (re para. 2.2.4 of the revised module): All AIs are currently required to observe non-statutory trigger ratios above their minimum CAR. When the capital buffers commence operation on 1 January 2016, the use of these trigger ratios will be discontinued. However, AIs will be expected to ensure that they have comparable internal targets or monitoring tools so that timely discussion with the MA can be undertaken if their capital levels fall close to the buffer zone.

Additional Pillar 2 guidance

In the revised module, more guidance and elaboration are provided in respect of certain areas of the SRP to take account of relevant standards and Pillar 2 guidance issued by the Basel Committee. These include:

(i) High cost credit protection transactions (re new Annex G to the revised module): Whilst credit risk mitigation techniques are recognised in the calculation of credit risk under

[5] For example, an AI may be assessed to be a significant outlier in some risk factors to the extent of affecting the AI's solvency and the seriousness of the AI's position cannot be accommodated by a maximum capital add-on of 8%.

the capital adequacy framework, the use of high cost credit protection transactions for risk mitigation purposes offers the potential for regulatory arbitrage. Annex G highlights the issues associated with such transactions, sets out the factors that AIs should take into account in analysing such transactions; and describes the MA's approach to scrutiny of any such transactions in his assessment under the SRP.

(ii) Counterparty credit risk (including exposure to central counterparties) (re new Annex H to the revised module): In assessing an AI's counterparty credit risk (CCR) under the SRP, the MA will focus substantially on the adequacy and effectiveness of the AI's CCR management systems, especially in respect of the key elements mentioned in subsections H2.1 to H2.9 of Annex H. This annex also (a) sets out the MA's approach to assessing AIs' use of the IMM(CCR) approach (and dealing with any issues identified); and (b) provides guidance on AIs' assessment under CAAP of their exposures to central counterparties, which may be a potential source of CCR for their centrally cleared trade exposures, and the MA's approach towards such exposures under the SRP.

(iii) Securitization risk and off-balance sheet exposures (re Annex E to the revised module): Annex E sets out the MA's expectations on how AIs should manage specific risks arising from their securitization exposures and assess such risks in their CAAP. More guidance is also provided in this annex to elaborate on the MA's approach to reviewing AIs' securitization transactions and addressing certain issues associated with such transactions under the SRP, such as significant risk transfer, implicit support, call provisions and securitization transactions with early amortization features. In cases where the Pillar 1 capital requirements do not sufficiently reflect the risks to which an AI is exposed in respect of its securitization exposures, the MA may consider increasing the AI's capital requirements under the SRP.

Implementation

The revised Pillar 2 framework will begin operation on 1 January 2013, to coincide with the commencement of the Basel III capital framework in Hong Kong. The transition to the Basel III-based capital ratios will be made by the MA serving a notice on each AI from 1 January 2013 specifying the section 97F minimum CAR applicable to the AI, which will be derived by reference to the minimum CAR[6] of the AI immediately in force before 1 January 2013 (as if that minimum CAR is the Total capital ratio under section 97F) and according to the apportionment method described above relating to the determination of section 97F minimum CAR.[7] Subject to any representations that may be made by an AI in response to the MA's notice, the section 97F minimum CAR of the AI will be in force until otherwise advised by the MA, following the conduct of the SRP on the AI after 1 January 2013.

Noting that there may be ongoing international discussions on issues concerning the application of Pillar 2 under Basel III, the MA will continue to monitor international standards or practices that may emerge from these discussions as well as the Pillar 2

---

[6] This refers to the minimum CAR imposed on the AI under section 101 of the Banking Ordinance (to be repealed on 1 January 2013).

[7] For example, if an AI's minimum CAR under section 101 is 10%, the Pillar 2 capital requirement of the AI is deemed to be 2% (i.e. 10% - 8%), which will then be used for deriving the section 97F minimum CAR according to the illustration in footnote 2 above.

approaches adopted by other regulators in major financial centres, and assess whether there are any implications for the Pillar 2 framework in Hong Kong.

On-line access to the SPM module is available to AIs under the icon for "Supervisory Policy Manual" on the MA's public (http://www.hkma.gov.hk) and private (http://www.stet.finnet.hk) websites.

Should you have any questions relating to the revised module, please contact Ms Rita Yeung at 2878 1388 or Mr Andy Cheung at 2878 1022.

Yours faithfully,

Karen Kemp
Executive Director (Banking Policy)

c.c. The Chairman, Hong Kong Association of Banks
The Chairman, The DTC Association
FSTB (Attn : Mr Jackie Liu)