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For information

Legislative Council Panel on Financial Affairs

Progress of preparations for the implementation of Basel II in Hong Kong

Purpose

This paper reports on the progress of preparations for the implementation of Basel II in Hong Kong.

2. The Banking (Amendment) Ordinance 2005 (BAO 2005), enacted in July 2005, amends various sections of the Banking Ordinance (BO) as necessary to establish the new capital regulatory regime for authorized institutions (AIs). One of the key amendments is the provision of a rule-making power enabling the Monetary Authority (MA) to promulgate rules prescribing the manner in which AIs' capital adequacy ratio (CAR) shall be calculated and information on financial affairs that AIs shall disclose. These rules, referred to as "Capital Rules" and "Disclosure Rules", will have the status of subsidiary legislation and will be subject to negative vetting by the Legislative Council.

3. This paper focuses in particular on the preparation of the rules, the consultation process, and preparations for the establishment of the Capital Adequacy Review Tribunal pursuant to the BAO 2005.

Background

4. The Capital Rules and Disclosure Rules ("the Rules") to be made by the MA under the new sections 98A and 60A of the BO (as in sections 4 and 2 of the BAO 2005 – set out in Annex A, which are not yet in operation), will form an integral part of a new capital regulatory regime to be adopted in Hong Kong to implement, in a manner considered appropriate for the particular circumstances of the local banking industry, the proposals contained in "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (commonly known as "Basel II") issued by the Basel Committee on Banking Supervision ("Basel Committee").

5. The proposals of the Basel Committee set out in Basel II have gained widespread international acceptance and the Government considers that, given Hong Kong's position as an international finance centre, it should be in the first wave of jurisdictions (alongside other major international financial centres such as London, Paris, Frankfurt and Tokyo) to establish a legal and regulatory framework broadly in

line with the international standards in Basel II. In implementing Basel II, however, due consideration should be given to, and appropriate adjustments should be made for, the particular circumstances of the local banking industry. Careful cost/benefit analysis should be undertaken, the aim being to make implementation as cost-effective as possible, and the additional cost burden placed on AIs by the new requirements should be explicitly taken into account.

6. The Capital Rules will set out the manner for calculating the CAR which AIs incorporated in Hong Kong must maintain. Nearly all jurisdictions with active banking markets require banking organisations to maintain at least a minimum level of capital to serve as a foundation for a bank's future growth and as a cushion against its unexpected losses. Capital levels are usually considered in the form of a capital adequacy ratio, expressed as a percentage, of a bank's capital base (being equity share capital, reserves, certain forms of subordinated debt and the like) to its exposures (which are allocated risk weights according to the class of obligor or exposure).

7. The Third Schedule to the BO, which sets out how the minimum capital requirement should be calculated under the existing framework, will be repealed when the Capital Rules are made.

8. The Disclosure Rules will set out the requirements for the public disclosure which AIs must make in respect of their profit and loss, state of affairs and CAR.

9. The MA has also been empowered under the BAO 2005 to issue guidelines to AIs on the manner in which the MA exercises his rule-making power.

10. In devising Basel II, the Basel Committee set itself the dual objectives of enhancing the risk sensitivity of the existing capital adequacy measure and providing incentives for banks to enhance risk measurement and management. Basel II is considerably more complex than its predecessor, Basel I. It extends the calculation of the CAR to cover a bank's exposure to operational risk, in addition to credit risk and market risk.[1] Moreover, different calculation approaches for each type of risk are available for adoption by individual banks, depending on their level of sophistication and risk profile.[2]

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[1] This is one of the three "pillars" of the Basel II requirements, Pillar 1, which sets out the minimum capital requirement for a bank's credit, market and operational risks. Pillar 2 requires that banks should have in place sound internal processes to assess the adequacy of their capital, based on a thorough evaluation of their risks including those risks not covered under Pillar 1, and that supervisors should carry out "supervisory review" of this process. Pillar 3 is to complement Pillars 1 and 2 by requiring banks to make public disclosure of their risk profiles, capital adequacy and internal risk management. Further details are given in Annex B to this paper.

[2] The menu of approaches to measuring risks, in order of increasing sophistication, for banks to choose under Basel II are: the Standardised Approach, the Foundation Internal Ratings–Based (IRB) Approach, and the Advanced IRB Approach for credit risk; the Basic Indicator Approach, the Standardised

Implementation timetable

11. Hong Kong's Basel II implementation timetable is in accordance with that recommended by the Basel Committee for its own members and endorsed by the industry. From January 2007, all AIs incorporated in Hong Kong will be required to follow Basel II. Initially, they will have a choice of three options for credit risk, namely Standardised Approach, Basic Approach, and Foundation IRB Approach, and from January 2008 a fourth option, namely Advanced IRB Approach, will be added. AIs choosing to adopt either of the IRB approaches can set their own implementation timetable. In other words, they can start on the Standardised or Basic Approach in January 2007, and then migrate to IRB whenever it suits them (as long as they can meet the qualifying criteria). This flexibility is appropriate because different AIs are at different stage of preparation for IRB, and some will be ready sooner than others; and because the large international banks are working to varying timetables (and some wish to implement IRB in all jurisdictions at the same time, while others wish to phase implementation). Legislation of all approaches by January 2007 will provide AIs with the certainty they need to plan their implementation of the revised capital regime.

12. The MA will continue to set minimum CARs for AIs on a case-by-case basis, in the range of 8-16% as provided for under section 101(1) of the BO. A draft guideline setting out the process by which the HKMA evaluates and monitors the capital adequacy of AIs and set the minimum CAR of AIs has been issued for industry consultation.

Major preparatory tasks

Policy setting

13. The HKMA has already issued all relevant Basel II implementation proposals, all of which have been endorsed by the banking industry. This means that the policy-setting stage of our implementation plan has been completed. The industry has played a critical role in this process, helping to ensure that the framework and the implementation approach are tailored to Hong Kong's circumstances while meeting the international standards required of banks. In converting the Basel II document into implementation proposals, the HKMA's work has benefited from the advice of the Basel II Consultation Group (BCG), which included representatives from the industry, the accounting profession and other interested parties; the two statutory advisory committees, i.e. the Banking

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Approach and the Advanced Measurement Approaches for operational risk; and the Standardised Approach and Internal Models Approach for market risk. For Hong Kong, the Hong Kong Monetary Authority (HKMA) has also made available a "Basic Approach" to measuring credit risk, which is essentially a modification of the existing framework and is mainly intended for use, with the prior approval of the MA, by AIs with small, simple and straightforward operations, and as an interim approach for those AIs developing IRB systems.

Advisory Committee and the Deposit-Taking Companies Advisory Committee; the two industry Associations, i.e. The Hong Kong Association of Banks and the DTC Association; other parties within the Government; and other interested parties.

Development of rules

14. Translating the Basel II requirements into legislation is a major task which different jurisdictions will undertake in different ways. The approach we have adopted in Hong Kong is that the HKMA has engaged a consultant draftsman to assist in the production of detailed Drafting Instructions (in the form of draft rules) so as to facilitate the drafting process. The HKMA, the Financial Services and the Treasury Bureau and the Department of Justice are collaborating closely on the drafting.

15. The Capital Rules are to be made under the new section 98A of the BO (as in section 4 of the BAO 2005) to prescribe the manner in which AIs incorporated in Hong Kong shall calculate their CAR under section 98 of the BO. The Capital Rules are in seven parts, as follows -

- **Part 1** specifies that the rules shall come into operation on a day to be appointed by the Secretary for Financial Services and the Treasury and defines the terms used in the rules.

- **Part 2** specifies the calculation approaches to calculate an AI's credit, operational and market risks and the qualifying criteria for using some of these approaches; the requirement for an AI to calculate its CAR on a solo (or solo-consolidated) basis and/or consolidated basis; and the appeal mechanism and the appealable decisions made by the MA under these Rules.

- **Part 3** specifies how an AI determines its capital base.

- **Parts 4–6** prescribes the methodologies to calculate an AI's credit risk, market risk and operational risk using the various approaches specified in Part 2.

- **Part 7** prescribes the asset securitization framework.

Further details are given in Annex C.

16. Given the length and complexity of the Basel II requirements, the Capital Rules have been prepared in four batches. Preliminary consultation of the industry on the first two batches has already been completed. The first batch concerns Part 4 of the Capital Rules insofar as it relates to the Standardized Approach to the calculation of credit risk and Part 5 of the Capital Rules dealing

with operational risk. Relevant definitions for inclusion in Part 1 of the Capital Rules are also included. The second batch relates to "Application of these Rules" in Part 2, "Determination of Capital Base" in Part 3 and the Basic Approach to calculation of credit risk in Part 4. The latest draft of these two batches of rules are enclosed as Annexes D and E to this paper for Members' reference.

17. Preliminary industry consultation on the third batch of draft rules, relating to the calculation of market risk in Part 6 and asset securitization in Part 7, is currently underway. The consultative draft of this batch is at Annex F for Members' reference. Preliminary industry consultation on the fourth batch of draft rules, covering the IRB Approach to the calculation of credit risk in Part 4 of the Capital Rules, is scheduled to be conducted in May 2006. We will make available to Panel Members copies of the fourth batch of draft rules once they are ready.

18. After the preliminary consultation, the whole set of draft Capital Rules will then be revised for a second round of consultation, the statutory consultation as required under the BAO 2005. The MA is subject to the statutory duty to consult the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, The Hong Kong Association of Banks, the DTC Association and the Financial Secretary when making the Capital Rules and Disclosure Rules. It is expected that the rules will be ready for gazette in September 2006 and tabling before the Legislative Council in early October for negative vetting.

19. The Disclosure Rules will bring the existing disclosure requirements broadly into line with the recommendations of the Pillar 3 framework of Basel II. They are being developed under the guidance of the Working Party on Financial Disclosure[3], the BCG and in consultation with the industry associations. The Rules will replace existing HKMA disclosure guidelines for reporting periods beginning January 2007. It is expected that the drafting of these rules and consultation on these rules can be completed in time for them to be introduced into the Legislative Council at the same time as the Capital Rules. For Members' reference, a policy paper outlining the requirements of the Disclosure Rules is enclosed at Annex G.

Consultation and dialogue with AIs

20. The HKMA has consulted the industry and other interested parties extensively throughout the long process of development of Basel II, the detailed implementation proposals for Hong Kong and the subsequent development of the Capital Rules and Disclosure Rules. There is strong support from the parties consulted, and their comments (which have mainly been of a technical nature) have been taken into account where appropriate in preparing the Rules. Feedback documents detailing major comments received in the consultation

[3] The Working Party on Financial Disclosure includes representatives from AIs, both locally and overseas incorporated, and members of the accounting and audit profession.

process and the HKMA's responses to them were issued to the industry associations and posted on the HKMA's website to facilitate AIs' continuing preparation for implementation of the revised framework.

21. The reporting form for the new CAR requirements together with detailed completion instructions have also been issued for the industry's reference. To enable AIs to become familiar with the new return and to assess the impact of the revised framework on their minimum capital requirement, they will be required to conduct parallel reporting of the existing CAR return and the relevant parts of the new return for certain specified periods this year.

22. Further, the HKMA has maintained a close dialogue with AIs to ensure that they can achieve compliance by the implementation date of January 2007, through bilateral meetings, industry briefing sessions, circulars and feature articles in the HKMA's quarterly bulletins and website. In the case of AIs that are subsidiaries of foreign banking groups, the HKMA will in implementing the Hong Kong framework co-ordinate with the home supervisors of these banking group to eliminate duplication and overlap of efforts.

23. Therefore, despite the lengthy process needed for the preparation of the Capital Rules and Disclosure Rules, we are of the view that sufficient guidance and time have been made available to AIs to prepare for implementation of Basel II.

Establishment of Capital Adequacy Review Tribunal

24. Under the BAO 2005, certain decisions of the MA made under the Capital Rules as specified in those rules are appealable to a tribunal known as the "Capital Adequacy Review Tribunal" (CART). The scope of responsibility of the CART will be limited to reviewing, upon application of aggrieved persons, major decisions of the MA made under the Capital Rules. As stated in the draft Capital Rules, the right of appeal will only lie in respect of the fundamental decision as to which approach to capital adequacy calculation an AI may adopt, which may have a material impact on the AI's capital requirement.

25. The CART, which is to be established towards end-2006, will consist of a chairman, who is qualified for appointment as a judge of the High Court, and at least two other members, not being public officers, to be appointed by the Chief Executive. The CART is expected to commence operation at the same time as the Capital Rules become effective. Given the HKMA's close dialogue with AIs in their preparation for implementing Basel II (e.g. on their choice of approaches to calculate capital charge), we expect the need for the CART to hear appeals to be minimal.

Way forward

26. So far, the HKMA has made good progress in the implementation of Basel II. AIs are also actively working towards compliance by the implementation date of January 2007 based on the implementation proposals and draft Rules issued to the industry. The HKMA will continue its preparatory work and its dialogue with AIs on their preparations for the implementation.

27. The implementation approach developed for Hong Kong and outlined above is, we believe, pragmatic and cost-effective. The close cooperation with the industry throughout the process has helped ensure that their wishes as regards the timetable for implementation, the available range of options, and the guidance to be issued, have mostly been able to be accommodated. Moreover, we have been very flexible on many aspects of the implementation: we have allowed an extended transition period for those planning to use the more advanced approaches; and have devised a simplified approach for the smaller institutions. And we have tried as much as possible to harmonise our requirements with those of other regulators, so that banks operating in multiple jurisdictions do not face multiple requirements.

28. There is a clear necessity for a timely completion of the legislative process of the Capital Rules and Disclosure Rules. Any delay in the legislative process will affect the target implementation date, and the position of Hong Kong as an international financial centre that prides itself on its commitment to always follow closely international supervisory standards.

Hong Kong Monetary Authority
April 2006

Annex A

Sections 4 and 2 of the Banking (Amendment) Ordinance 2005

(not yet in operation)

4. Section added

The following is added –

"**98A. Calculation of capital adequacy ratio**

(1) The Monetary Authority may, after consultation with the Financial Secretary and the persons specified in subsection (2), make rules prescribing the manner in which the capital adequacy ratio of authorized institutions shall be calculated.

(2) The persons specified for the purposes of subsection (1) are –

(a) the Banking Advisory Committee;

(b) the Deposit-taking Companies Advisory Committee;

(c) The Hong Kong Association of Banks; and

(d) The DTC Association.

(3) Rules made under subsection (1) may provide for the Monetary Authority, on application made to him by an authorized institution aggrieved by a decision of the Monetary Authority made in relation to it under those rules, to review his decision.

(4) Rules made under subsection (1) may provide that a decision made by the Monetary Authority under those rules is a decision to which section 101B(1) applies.

(5) For the avoidance of doubt, it is hereby declared that any requirement under subsection (1) for the Monetary Authority to consult with any person shall not operate to prevent the Monetary Authority from consulting with such other person as the Monetary Authority thinks fit.".

2. Section substituted

Section 60A of the Banking Ordinance (Cap. 155) (as inserted by section 6 of the Banking (Amendment) Ordinance 1999 (42 of 1999) and further amended by section 24(4) of the Banking (Amendment) Ordinance 2001 (32 of 2001)) is repealed and the following substituted –

"**60A. Disclosure to the general public of information relating to financial affairs**

(1) The Monetary Authority may, after consultation with the Financial Secretary and the persons specified in subsection (2), make rules prescribing the information to be disclosed to the general public by authorized institutions relating to their state of affairs, profit and loss or capital adequacy ratio and prescribing the manner in which, times at which and periods during which such information shall be so disclosed.

(2) The persons specified for the purposes of subsection (1) are –

(a) the Banking Advisory Committee;

(b) the Deposit-taking Companies Advisory Committee;

(c) The Hong Kong Association of Banks; and

(d) The DTC Association.

(3) Rules made under subsection (1) may make different provision for

authorized institutions belonging to different classes of authorized institution.

(4) Where an authorized institution fails to comply with any requirement applicable to it contained in rules made under subsection (1), every director, every chief executive and every manager of the authorized institution commits an offence and is liable –

(a) on conviction upon indictment to a fine at tier 7; or

(b) on summary conviction to a fine at tier 5,

and, in the case of a continuing offence, to a further fine at tier 2 for every day during which the offence continues.

(5) For the avoidance of doubt, it is hereby declared that any requirement under subsection (1) for the Monetary Authority to consult with any person shall not operate to prevent the Monetary Authority from consulting with such other person as the Monetary Authority thinks fit.”.

Annex B

Basic features of Basel II

1. Basel II consists of three mutually reinforcing "pillars" that are designed to allow both banks and their supervisors to properly evaluate the various risks faced by banks. The Capital Rules will cover matters falling within pillar 1 and the Disclosure Rules will cover matters falling within pillar 3.

(I) Pillar 1 – Minimum Capital Requirements

2. This pillar prescribes how the minimum CAR is to be calculated for a bank's exposure to credit risk, operational risk and market risk and offers different approaches to the calculation of capital requirements.

3. The HKMA considers it appropriate, in view of the widely differing business focus, size and complexity of AIs and the nature and combination of risks which they face, to allow AIs a measure of flexibility in selecting the approaches to be adopted under pillar 1. The following three options will be available in Hong Kong for calculating the minimum capital requirement for credit risk -

3.1 Basic Approach – it is anticipated that this will mostly be adopted by the smaller AIs (i.e. restricted licence banks and deposit-taking companies whose total assets fall below HK$10 billion). This option will allow them to use the current capital framework for risk-weighting all credit exposures, subject to a few technical adjustments and the imposition of a capital charge for operational risk, so as to align more closely with Basel II;

3.2 Internal Ratings-based (IRB) Approach – it is anticipated that this will mostly be adopted by larger AIs. AIs will be able to rely on their own internal rating systems for assessments of credit risk in order to calculate the capital which they must hold, provided that they can satisfy their supervisors that their systems meet a set of minimum supervisory standards. Depending on the level of sophistication of their internal rating systems, AIs may choose from a range of approaches available under the IRB framework for different types of asset class or exposure. This option will allow AIs to use the Foundation or Advanced IRB Approach for sovereign, bank or corporate exposures and other available IRB approaches applicable to different types of asset class or exposure; and

3.3 Standardized Approach – it is anticipated that this option will be adopted by medium sized AIs. This is conceptually similar to the current capital framework. However, the classification of AIs' counterparties and of assets and other items in AIs' business portfolios and the determination of risk-weightings applicable to them are more risk-sensitive. Credit exposures to various types of counterparty, e.g. sovereigns, banks and corporates, will be assigned different risk-weightings based upon assessments by recognised external credit assessment institutions (such as Moody's Investors Service, Inc. and Standard & Poor's Corporation). This option will require the use of the Standardized Approach for the risk-weighting of all credit exposures.

4. Under Basel II, capital is explicitly required to be held by banks to cover operational risk**,** which is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people or systems or from external events. Basel II incorporates three options for the calculation of operational risk: Basic Indicator Approach, Standardized Approach and Advanced Measurement Approaches. The HKMA's policy in Hong Kong is that only the Basic Indicator Approach and the Standardized Approach (including an Alternative Standardized Approach which is provided for in a footnote on page 139 of Basel II), will initially be available for AIs. The Alternative Standardized Approach is similar to the Standardized Approach save that it provides for slightly different treatment for commercial banking and retail banking business lines. AIs intending to use the Standardized Approach (or Alternative Standardized Approach) will need to seek the prior approval of the MA. Techniques to be used in respect of the Advanced Measurement Approaches are still evolving and so, initially at least, these Approaches will not be available to AIs.

5. The principles and rules for calculating the market risk capital requirement were introduced by the Basel Committee in 1996 in an amendment to the 1988 Basel Accord. Capital requirements are prescribed for an AI's "trading book", consisting of positions in financial instruments and commodities, using either the Standardized Approach (based on a standardized framework set by the Basel Committee for less sophisticated banks) or, subject to supervisory approval of the model, the Internal Models Approach (for active market participants who have developed sophisticated model based systems for measuring market risks) subject to a de minimis exemption for AIs with insignificant market risk exposures. These principles and rules remain largely unchanged under Basel II, except for some refinements such as changes in the definitions of what constitutes a "trading book" and the use of external credit ratings for determining the risk-weight for debt securities issued by central governments or central banks or monetary authorities.

(II) Pillar 2 – Supervisory Review Process

6. This pillar sets out key requirements applicable to both banking supervisors and banks with a view to ensuring that, through the supervisory review process, banks will not only have adequate capital to support the risks inherent in their business but will also be encouraged to develop and use improved risk management techniques in monitoring and managing these risks. The key elements of pillar 2 include:-

6.1 banks to assess and maintain capital in relation to their individual risk profile;

6.2 banking supervisors to ensure compliance with paragraph 6.1 and take supervisory action if necessary;

6.3 banking supervisors to ensure banks operate above minimum CARs; and

6.4 banking supervisors to intervene and require prompt remedial action at an early stage to prevent capital falling below minimum levels.

(III) Pillar 3 – Market Discipline

7. This pillar is to complement pillars 1 and 2 by encouraging market discipline through the <u>public</u> disclosure of key information on risk exposures and capital adequacy. The BO currently provides in section 60 for the public disclosure of AIs' audited annual accounts. In addition, a new section 60A of the BO (inserted by section 2 of the BAO 2005) empowers the MA to require public disclosure of information relating to the state of affairs, profit and loss or CAR of AIs.

Annex C

Structure of the Rules

1. It is currently envisaged that the Capital Rules will be divided into 7 parts as follows:-

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Qualifying criteria for the use of calculation approaches
Solo, solo-consolidated and consolidated bases for calculation of capital adequacy ratio
Appeals

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Part 4 – Calculation of Credit Risk
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Calculation of credit risk under Basic Approach

Part 5 – Calculation of Operational Risk
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Standardized Approach to calculation of operational risk
Alternative Standardized Approach to calculation of operational risk
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Part 6 – Calculation of Market Risk

Part 7 – Asset Securitization

2. However, once a full draft of all of the Capital Rules is available, consideration will be given as to whether it is necessary to have a separate part of the Rules for each calculation approach (e.g. for Credit Risk a separate part for the Basic Approach, the Standardized Approach and the IRB Approach).

3. It is currently envisaged that the Disclosure Rules will be divided into 9 parts as follows:

Part 1 – Preliminary

Part 2 – General Principles

Part 3 – General Requirements

Part 4 – Disclosures Applicable to all Hong Kong Incorporated Authorized Institutions

Part 5 – Additional Disclosures specific to Hong Kong Incorporated Authorized Institutions under the Basic Approach

Part 6 – Additional Disclosures specific to Hong Kong Incorporated Authorized Institutions under the Standardized Approach

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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 standardised 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 standardised approach;

"asset sales 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; and

(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 *rules [..]*;

"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" ( ) means a day which is not a public holiday;

"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 -

(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 for the institution, on an allocated basis, 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 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 *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 the use by an authorized institution of collateral falling within *rule 35* to calculate the risk-weighted amount of its on-balance sheet assets and off-balance sheet exposures in accordance with the provisions of *Division 7* of *Part 4*;

"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 an exposure to which would fall within the definition of "regulatory retail exposure";

"counter-guarantee" ( ), in relation to an authorized institution, means a guarantee (or other payment 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, purchased 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 protection" ( ), in relation to an exposure of an authorized institution, means the protection afforded the exposure by recognized credit risk mitigation;

"credit quality grade" ( ) means a grade represented by the numerals 1, 2, 3, 4, 5 or 6, as the case may be, 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;

"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;

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

"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 issue specific rating" ( ), in relation to a debt obligation issued or undertaken by a person (howsoever described), means -

(a) in *rules 10* and *12*, a long-term credit assessment rating assigned to the obligation by an ECAI; and

(b) in *rules 14*, *15* and *16*, a short-term or long-term credit assessment rating assigned to the obligation by an ECAI;

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

"ECAI rating" ( ) means -

(a) an ECAI issuer rating; or

(b) an ECAI issue specific rating;

"equity contract" ( ) means a forward, swap, purchased 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 contract, cross-currency interest rate swap, purchased currency option or similar derivative contract; and

(b) includes a forward, swap, purchased 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 pre-determined 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 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;

"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 agreement, interest rate swap, purchased 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 *rules [..]*;

"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;

"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 recognised 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 recognised credit risk mitigation, means the revaluation of the transaction, contract or recognised credit risk mitigation, as the case may be, at current market rates;

"minimum holding period" ( ), in relation to collateral or any other 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 recognised 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 recognised 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 recognised by the institution from its shareholdings in other companies; and

(C) fees and commissions recognised by the institution (including any fees and commissions recognised 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 recognised by the institution from disposals of items of property, plant and equipment of the institution;

(iii) income recognised by the institution from disposals of non-trading investments of the institution;

(iv) litigation settlements in favour of the institution; and

(v) income recognised 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, purchased option or similar derivative contract the value of which is derived from the value of commodities (including energy, agricultural assets, base metals and 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 pre-determined 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, purchased 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; and

(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 8*, the contracted amount of the exposure;

(ii) in the case of an exposure listed in *Table 8* 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 9*, the notional amount of the exposure;

(iv) in the case of an exposure listed in *Table 9* 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 *subrule (5)(b)* to be a public sector entity for the purposes of these Rules; 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;

"recognised collateral" ( ) -

(a) in relation to the simple approach to the treatment of collateral, means collateral falling within *rule 34*;

(b) in relation to the comprehensive approach to the treatment of collateral, means collateral falling within *rule 35*;

"recognised credit derivative contract" ( ) means -

(a) a credit derivative contract falling within *rule 55(1)*;

(b) a credit derivative contract falling within *rule 55(2)* to the extent that it is deemed under that rule to be a recognised credit derivative contract;

"recognised 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 recognised collateral, recognised credit derivative contracts, recognised guarantees, or recognised 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;

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

"recognised guarantee" ( ) means a guarantee falling within *rule 54*;

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

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

(a) subject to *paragraph (b)*, means any financial exposure of the institution -

(i) to a natural person or small business; and

(ii) where the transaction creating the financial exposure, whether drawn down or not, takes the form of an advance or extension of credit that is -

(A) an overdraft or other line of credit;

(B) an instalment loan, auto loan or lease or other personal term loan or advance by way of leasing facilities;

(C) a credit card or other revolving credit; or

(D) a credit facility or commitment to lend funds or advance a credit facility to a small business; and

(iii) where the maximum aggregate retail exposure (including any past due exposure) to a single counterparty, or to a group of counterparties considered as a group of counterparties, under section 81(1)(a), (b), (c) or (d) of the Ordinance, does not exceed HK $10 million on the assumptions that -

(A) in the case of an on-balance sheet asset, the amount of the exposure is the principal amount;

(B) in the case of an off-balance sheet exposure that is an OTC derivative transaction or credit derivative contract, the amount of the exposure is the credit equivalent amount of the exposure; and

(C) in the case of an off-balance sheet exposure not falling within *sub-subparagraph (B)*, the amount of the exposure is the principal amount multiplied by the applicable credit conversion factor;

(b) does not include any financial exposure of the institution which -

(i) is a residential mortgage loan (other than a residential mortgage loan falling within *rule 19(4)(a)*);

(ii) is a holding of equity securities, whether listed or unlisted; or

(iii) is a past due exposure;

"relevant international organisation" ( ) means an international organisation specified in a notice under *subrule (5)(d)* to be a relevant international organisation for the purposes of these Rules;

"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 a notice under *subrule (5)(h)* to be a restricted collective investment scheme for the purposes of these Rules;

"restricted jurisdiction" ( ) means a jurisdiction specified in a notice under *subrule (5)(a)* to be a restricted jurisdiction for the purposes of these Rules;

"restricted foreign public sector entity" ( ) means a foreign public sector entity specified in a notice under *subrule (5)(c)* to be a restricted foreign public sector entity for the purposes of these Rules;

"restricted securities regulator" ( ) means a securities regulator specified in a notice under *subrule (5)(g)* to be a restricted securities regulator for the purposes of these Rules;

"restricted sovereign" ( ) means a sovereign specified in a notice under *subrule(5)(e)* to be a restricted sovereign for the purposes of these Rules;

["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; 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 the use by an authorized institution of collateral falling within *rule 34* to calculate the risk-weighted amount of its on-balance sheet assets and off-balance sheet exposures in accordance with the provisions of *Division 6A* of *Part 4*;

"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 HK $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 HK $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 HK $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 organisation;

"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;

"standardised 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 4*;

(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*;

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

"standard supervisory haircut" ( ), in relation to the use by an authorized institution of the STC to calculate its credit risk, means a haircut specified in *Schedule 3*;

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

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

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

"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;

"transfer risk" ( ) means a risk which is transferred from one party to another party by the use of risk management techniques;

["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 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) The Monetary Authority may, by notice published in the Gazette -

(a) specify a jurisdiction to be a restricted jurisdiction for the purposes of these Rules;

(b) specify an entity to be a public sector entity for the purposes of these Rules;

(c) specify a foreign public sector entity to be a restricted foreign public sector entity for the purposes of these Rules;

(d) specify an international organisation to be a relevant international organisation for the purposes of these Rules;

(e) specify a sovereign to be a restricted sovereign for the purposes of these Rules;

[(f) paragraph not used;]

(g) specify a securities regulator to be a restricted securities regulator for the purposes of these Rules;

(h) specify a collective investment scheme to be a restricted collective investment scheme for the purposes of these Rules.

(6) For the avoidance of doubt, it is hereby declared that a notice under *subrule (4)* or *(5)* is not subsidiary legislation.

PART 2

APPLICATION OF THESE RULES

3. Calculation of operational risk

An authorized institution shall -

(a) subject to *paragraphs (b)* and *(c)*, only use the BIA to calculate its operational risk;

(b) subject to *paragraph (c)* and *rule 4*, only use the STO to calculate its operational risk if it has the approval to do so under *rule 5*;

(c) subject to *rule 4*, only use the ASA to calculate its operational risk if it has the approval to do so under *rule 5*.

4. Monetary Authority may require authorized institution to use BIA to calculate its operational risk instead of STO or ASA

(1) Where -

(a) an authorized institution is using the STO or ASA to calculate its operational risk; and

(b) the Monetary Authority is satisfied that, if the institution were to make a fresh application under *rule 5* for approval to use the STO or ASA to calculate its operational risk, such approval would be refused,

then the Monetary Authority may, by notice in writing given to the institution, require the institution to calculate its operational risk by using the BIA instead of the STO or ASA, as the case may be -

(c) in respect of all of its business, or parts of its business, as specified in the notice; and

(d) beginning on such date, or the occurrence of such event, as is specified in the notice and ending on such date, or the occurrence of such event, as is specified in the notice.

(2) An authorized institution shall comply with the requirements of a notice given to it under *subrule (1)*.

5. Application by authorized institution for approval to use STO or ASA to calculate its operational risk

(1) An authorized institution may make an application to the Monetary Authority for approval to calculate its operational risk by using the STO or ASA.

(2) Subject to *subrules (3)* and *(4)*, the Monetary Authority shall determine an application under *subrule (1)* from an authorized institution by -

(a) granting approval to the institution to calculate its operational risk by using the STO or ASA; or

(b) refusing to grant such approval.

(3) Without limiting the generality of *subrule (2)(b)*, the Monetary Authority shall refuse to grant approval to an authorized institution to use the STO or ASA to calculate its operational risk if any one or more of the criteria specified in *Schedule 1* applicable to or in relation to the institution are not fulfilled with respect to the institution.

(4) The Monetary Authority shall not grant approval to an authorized institution to use the ASA to calculate its operational risk unless the institution satisfies the Monetary Authority that the use of the ASA would provide a more accurate assessment of the degree of operational risk to which the institution is exposed than would the use of the STO.

PART 3

DETERMINATION OF CAPITAL BASE

(This Part is temporarily vacant)

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 STC to calculate its credit risk.

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

7. Standardised approach to calculation of credit risk

(1) Subject to *subrule (2)*, an authorized institution shall calculate its capital adequacy ratio, in relation to credit risk, as the ratio (expressed as a percentage) of the institution's capital base to an amount ("relevant amount") representing the degree of risk-weighted credit risk to which the institution is exposed obtained 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 *rule 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) Subject to *subrule (3)*, an authorized institution may, in calculating its capital adequacy ratio 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 recognised credit risk mitigation in respect of the on-balance sheet asset or off-balance sheet exposure, as the case may be.

(3) Where an on-balance sheet asset or off-balance sheet exposure of an authorized institution has a current ECAI issue specific rating, the institution shall not under *subrule (2)* take into account the effect of any recognised credit risk mitigation applicable to the asset or exposure, as the case may be, which has already been taken into account in that rating.

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 *rules [..]* and *[..]* are required to be deducted from the institution's core or supplementary capital;

(ii) subject to the requirements of *Part 6*; or

(iii) 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) claims on sovereigns;

(b) claims on public sector entities;

(c) claims on multilateral development banks;

(d) claims on banks;

(e) claims on securities firms;

(f) claims on corporates;

(g) cash items;

(h) regulatory retail exposures;

(i) residential mortgage loans;

(j) other assets which are not past due exposures; and

(k) past due exposures.

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

10. Claims on sovereigns

(1) Where a sovereign has a current ECAI issuer rating, or a debt obligation issued or undertaken by the sovereign has a current ECAI issue specific rating, then an authorized institution shall map the ECAI issuer rating or ECAI issue specific rating, as the case may be, to a scale of uniform credit quality grades represented by the numerals 1, 2, 3, 4, 5 and 6 in accordance with *Table A* set out in *Schedule 2*.

(2) Subject to *rules 11* and *22*, an authorized institution shall allocate a risk-weight to a claim on a sovereign which falls within *subrule (1)* in accordance with *Table 1*.

Table 1

Risk-weighting of claims on sovereigns

Credit quality grade (sovereigns)	1	2	3	4	5	6
Risk-weight	0%	20%	50%	100%	100%	150%

(3) Where a sovereign has neither -

(a) a current ECAI issuer rating; nor

(b) a current ECAI issue specific rating (including a current short-term ECAI issue specific rating) assigned to a debt obligation issued or undertaken by the sovereign,

then an authorized institution shall allocate a risk-weight of 100% to a claim by the institution on the sovereign.

11. Exceptions to *rule 10*

Where -

(a) a claim on a sovereign by an authorized institution consists of a domestic currency claim on the Government (including a claim for the account of the Exchange Fund), then the institution shall allocate a risk-weight of 0% to the claim;

(b) a claim on a sovereign by an authorized institution consists of a domestic currency claim on a sovereign (other than the Government or a restricted sovereign) and the relevant banking supervisory authority for the jurisdiction of the sovereign permits banks carrying on banking business in the jurisdiction to allocate a risk-weight to the claim which is lower than the risk-weight which would be allocated under *rule 10* to the claim, then the institution may allocate the lower risk-weight to the claim;

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

12. Claims on public sector entities

(1) Subject to *subrule (2)*, where a claim on a public sector entity by an authorized institution consists of a claim on a domestic public sector entity, then the institution shall allocate a risk-weight to the claim which is applicable to the credit quality grade which is the next numerically higher credit quality grade than the credit quality grade that is allocated to the Government on the basis of a current ECAI issuer rating (or, if there is no such higher credit quality grade, the credit quality grade so allocated to the Government).

(2) Where a claim on a public sector entity by an authorized institution consists of a claim on a foreign public sector entity, then -

(a) subject to *paragraphs (b)*, *(c)* and *(d)*, the institution shall allocate a risk-weight to the claim which is applicable to the credit quality grade which is the next numerically higher credit quality grade than the credit quality grade that is allocated to the sovereign of the jurisdiction in which that entity is incorporated or otherwise established on the basis of a current ECAI issuer rating (or, if there is no such higher credit quality grade, the credit quality grade so allocated to the sovereign);

(b) if the entity is a sovereign foreign public sector entity, *rule 10* shall, with all necessary modifications, apply to the claim as if the entity were a sovereign;

(c) if credit quality grade 5 has been allocated to a sovereign referred to in *paragraph (a)* on the basis of a current ECAI issuer rating, the institution shall allocate a risk-weight of 100% to the claim;

(d) if no credit quality grade has been allocated to a sovereign referred to in *paragraph (a)* on the basis of a current ECAI issuer rating, the institution shall allocate a risk-weight of 100% to the claim.

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

(1) Subject to *subrule (2)*, where a bank has a current ECAI issuer rating, or a debt obligation issued or undertaken by the bank has a current ECAI issue specific rating, then an authorized institution shall map the ECAI issuer rating or ECAI issue specific rating, as the case may be, to a scale of uniform credit quality grades represented by the numerals 1, 2, 3, 4 and 5 in accordance with *Table B* set out in *Schedule 2*.

(2) Where a current ECAI issue specific rating referred to in *subrule (1)* is a short-term issue specific rating as referred to in *subrule (6)*, then *subrules (6)* and *(7)* shall apply.

(3) Subject to *subrules (4)* to *(11)* and *rule 22*, an authorized institution shall allocate a risk-weight to a claim by it on a bank in accordance with *Table 2*.

Table 2

Risk-weighting of claims on banks

Credit quality grade (banks)	1	2	3	4	5
Risk-weight for general claims	20%	50%	50%	100%	150%
Risk-weight for 3 months' claims (other than a claim which has a current short-term ECAI issue specific rating)	20%	20%	20%	50%	150%

(4) Where a bank has neither -

(a) a current ECAI issuer rating; nor

(b) a current ECAI issue specific rating (including a current short-term ECAI issue specific rating) assigned to a debt obligation issued or undertaken by the bank,

then, subject to *subrule (5)*, an authorized institution shall allocate a risk-weight of -

(c) 50% to a general claim by it on the bank;

(d) 20% to a 3 months' claim by it on the bank.

(5) Where a bank falls within *subrule (4)*, then -

(a) subject to *paragraph (b)*, an authorized institution shall not allocate a risk-weight to a claim by it on the bank which is lower than the risk-weight attributable to the credit quality grade applicable to the sovereign of the jurisdiction in which the bank is incorporated or otherwise established on the basis of the sovereign's current ECAI issuer rating;

(b) if the sovereign referred to in *paragraph (a)* does not have a current ECAI issuer rating, an authorized institution shall allocate a risk-weight of 100% to a claim by it on the bank.

(6) Where a bank has a current short-term ECAI issue specific rating assigned to a claim on it by an authorized institution, then the institution shall map that rating to a scale of uniform credit quality grades represented by the numerals 1, 2, 3 and 4 in accordance with *Table D* set out in *Schedule 2*.

(7) Subject to *subrule (11)* and *rule 22*, where a bank has a current short-term ECAI issue specific rating assigned to a claim on it by an authorized institution, then the institution shall allocate a risk-weight to the claim in accordance with *Table 3*.

Table 3

Risk-weighting of claims on banks with a current short-term ECAI issue specific rating

Credit quality grade (banks)	1	2	3	4
Risk-weight for claims on banks with a current short-term ECAI issue specific rating	20%	50%	100%	150%

(8) Subject to *subrules (10)* and *(11)* and *rule 22*, where -

(a) a 3 months' claim ("concerned claim") by an authorized institution on a bank does not have a current short-term ECAI issue specific rating;

(b) the bank has a current short-term ECAI issue specific rating assigned to another 3 months' claim ("reference claim") on it by the institution or by another person (including another authorized institution); and

(c) if *subrules (6)* and *(7*) applied to the reference claim, the risk-weight that would be allocated pursuant to those subrules to the reference claim would be higher than -

(i) the risk-weight that would be allocated to the concerned claim pursuant to *subrule (3)* if –

(A) the bank has a current ECAI issuer rating or a current long-term ECAI issue specific rating

assigned to a debt obligation issued or undertaken by the bank; and

(B) *subrule (3)* applied to the concerned claim;

(ii) 20% if the bank has neither a current ECAI issuer rating nor a current long-term ECAI issue specific rating assigned to a debt obligation issued or undertaken by the bank,

then the institution shall allocate to the concerned claim the same risk-weight that would be allocated to the reference claim pursuant to *subrules (6)* and *(7)*.

(9) Subject to *subrules (10)* and *(11)* and *rule 22*, where -

(a) a 3 months' claim ("concerned claim") by an authorized institution on a bank does not have a current short-term ECAI issue specific rating;

(b) the bank has a current short-term ECAI issue specific rating assigned to another 3 months' claim ("reference claim") on it by the institution or by another person (including another authorized institution); and

(c) if *subrules (6)* and *(7)* applied to the reference claim, the risk-weight that would be allocated pursuant to those subrules to the reference claim would be -

(i) lower than the risk-weight that would be allocated to the concerned claim pursuant to *subrule (3)* if -

(A) the bank has a current ECAI issuer rating or a current long-term ECAI issue specific rating

assigned to a debt obligation issued or undertaken by the bank; and

(B) *subrule (3)* applied to the concerned claim;

(ii) 20% if the bank has neither a current ECAI issuer rating nor a current long-term ECAI issue specific rating assigned to a debt obligation issued or undertaken by the bank,

then the institution shall allocate to the concerned claim –

(d) the risk-weight that would be allocated to the concerned claim pursuant to *subrule (3)* if the bank has a current ECAI issuer rating or a current long-term ECAI issue specific rating assigned to a debt obligation issued or undertaken by the bank;

(e) a risk-weight of 20% if the bank has neither a current ECAI issuer rating nor a current long-term ECAI issue specific rating assigned to a debt obligation issued or undertaken by the bank.

(10) Where -

(a) pursuant to *subrules (6)* and *(7)* an authorized institution allocates a risk-weight of 150% to a claim by it on a bank; or

(b) the institution knows that -

(i) the bank has a current short-term ECAI issue specific rating assigned to a claim on it by another person (including another authorized institution); and

(ii) if *subrules (6)* and *(7)* applied to the claim referred to in *subparagraph (i)*, it would be allocated a risk-weight of 150% pursuant to those subrules,

then the institution shall allocate a risk-weight of 150% to each other general claim or 3 months' claim by it on the bank which does not have a current ECAI issue specific rating.

(11) Notwithstanding any other provision of this rule, an authorized institution may allocate a risk-weight of 20% to a 3 months' claim by it on a bank if the claim is denominated and funded in Hong Kong dollars.

(12) In this rule -

"general claim" ( ) means any claim by an authorized institution on a bank other than a 3 months' claim;

"3 months' claim" ( ) means a claim by an authorized institution on a bank with an original maturity of not more than 3 months from drawdown where the institution does not expect or anticipate that the facility to which the claim relates will be rolled over at the expiration of the original period.

15. Claims on securities firms

(1) Subject to *subrule (2)*, where a securities firm has a current ECAI issuer rating, or a debt obligation issued or undertaken by the firm has a current ECAI issue specific rating, then an authorized institution shall map the ECAI issuer rating or ECAI issue specific rating, as the case may be, to a scale of uniform credit quality grades represented by the numerals 1, 2, 3, 4 and 5 in accordance with *Table B* set out in *Schedule 2*.

(2) Where a current ECAI issue specific rating referred to in *subrule (1)* is a short-term issue specific rating as referred to in *subrule (6)*, then *subrules (6)* and *(7)* shall apply.

(3) Subject to *subrules (4)* to *(9)* and *rule 22*, an authorized institution shall allocate a risk-weight to a claim by it on a securities firm in accordance with *Table 4*.

Table 4

Risk-weighting of claims on securities firms

Credit quality grade (securities firms)	1	2	3	4	5
Risk-weight	20%	50%	50%	100%	150%

(4) Where a securities firm has neither -

(a) a current ECAI issuer rating; nor

(b) a current ECAI issue specific rating (including a current short-term ECAI issue specific rating) assigned to a debt obligation issued or undertaken by it,

then, subject to *subrule (5)*, an authorized institution shall allocate a risk-weight of 50% to a claim by it on the firm.

(5) Where a securities firm falls within *subrule (4)*, then -

(a) subject to *paragraph (b)*, an authorized institution shall not allocate a risk-weight to a claim by it on the firm lower than the risk-weight attributable to the credit quality grade applicable to the sovereign of the jurisdiction in which the firm is incorporated or otherwise established on the basis of the sovereign's current ECAI issuer rating;

(b) if the sovereign referred to in *paragraph (a)* does not have a current ECAI issuer rating, an authorized institution shall allocate a risk-weight of 100% to a claim by it on the firm.

(6) Where a securities firm has a current short-term ECAI issue specific rating assigned to a claim on it by an authorized institution, then the institution shall map that rating to a scale of uniform credit quality grades represented by the numerals 1, 2, 3 and 4 in accordance with *Table D* set out in *Schedule 2*.

(7) Subject to *rule 22*, where a securities firm has a current short-term ECAI issue specific rating assigned to a claim on it by an authorized institution, then the institution shall allocate a risk-weight to the claim in accordance with *Table 5*.

Table 5

Risk-weighting of claims on securities firms with a current short-term ECAI issue specific rating

Credit quality grade (securities firms)	1	2	3	4
Risk-weight for claims on securities firms with a current short-term ECAI issue specific rating	20%	50%	100%	150%

(8) Where -

(a) pursuant to *subrules (6)* and *(7)* an authorized institution allocates a risk-weight of 150% to a claim by it on a securities firm; or

(b) the institution knows that -

(i) the securities firm has a current short-term ECAI issue specific rating assigned to a claim on it by another person (including another authorized institution); and

(ii) if *subrules (6)* and *(7)* applied to the claim referred to in *subparagraph (i)*, it would be allocated a risk-weight of 150% pursuant to those subrules,

then the institution shall allocate a risk-weight of 150% to each other claim by it on the securities firm which does not have a current ECAI issue specific rating.

(9) Where -

(a) pursuant to *subrules (6)* and *(7)* an authorized institution allocates a risk-weight of 50% or 100% to a claim by it on a securities firm; or

(b) the institution knows that -

(i) the securities firm has a current short-term ECAI issue specific rating assigned to a claim on it by another person (including another authorized institution); and

(ii) if *subrules (6)* and *(7)* applied to the claim referred to in *subparagraph (i)*, it would be allocated a risk-weight of 50% or 100% pursuant to those subrules,

then the institution shall not allocate a risk-weight of less than 100% to each other claim -

(c) by it on the firm;

(d) which does not have a current short-term ECAI issue specific rating; and

(e) with an original maturity not greater than that of the claim referred to in *paragraph (a)* or *(b)(i)*, whichever is the greater.

16. Claims on corporates

(1) Subject to *subrule (2)*, where a corporate has a current ECAI issuer rating, or a debt obligation issued or undertaken by the corporate has a current ECAI issue specific rating, then an authorized institution shall map the ECAI issuer rating or ECAI issue specific rating, as the case may be, to a scale of uniform credit quality grades represented by the numerals 1, 2, 3, 4 and 5 in accordance with *Table C* set out in *Schedule 2*.

(2) Where a current ECAI issue specific rating referred to in *subrule (1)* is a short-term issue specific rating as referred to in *subrule (6)*, then *subrules (6)* and *(7)* shall apply.

(3) Subject to *subrules (4)* to *(9)* and *rule 22*, an authorized institution shall allocate a risk-weight to a claim by it on a corporate in accordance with *Table 6*.

Table 6

Risk-weighting of claims on corporates

Credit quality grade (corporates)	1	2	3	4	5
Risk-weight	20%	50%	100%	100%	150%

(4) Where a corporate has neither -

(a) a current ECAI issuer rating; nor

(b) a current ECAI issue specific rating (including a current short-term ECAI issue specific rating) assigned to a debt obligation issued or undertaken by it,

then, subject to *subrule (5)*, an authorized institution shall allocate a risk-weight of 100% to a claim by it on the corporate.

(5) Where a corporate falls within *subrule (4)*, then -

(a) subject to *paragraph (b)*, an authorized institution shall not allocate a risk-weight to a claim by it on the corporate which is lower than the risk-weight attributable to the credit quality grade applicable to the sovereign of the jurisdiction in which the corporate is incorporated or otherwise established on the basis of the sovereign's current ECAI issuer rating;

(b) if the sovereign referred to in *paragraph (a)* does not have a current ECAI issuer rating, an authorized institution shall allocate a risk-weight of 100% to a claim by it on the corporate.

(6) Where a corporate has a current short-term ECAI issue specific rating assigned to a claim on it by an authorized institution, then the institution shall map the ECAI issue specific rating to a scale of uniform credit quality grades represented by the numerals 1, 2, 3 and 4 in accordance with *Table D* set out in *Schedule 2*.

(7) Subject to *rule 22*, where a corporate has a current short-term ECAI issue specific rating assigned to a claim on it by an authorized institution, then the institution shall allocate a risk-weight to the claim in accordance with *Table 7*.

Table 7

Risk-weighting of claims on corporates with a current short-term ECAI issue specific rating

Credit quality grade (corporates)	1	2	3	4
Risk-weight for claims on corporates with a current short-term ECAI issue specific rating	20%	50%	100%	150%

(8) Where -

(a) pursuant to *subrules (6)* and *(7)* an authorized institution allocates a risk-weight of 150% to a claim by it on a corporate; or

(b) the institution knows that -

(i) the corporate has a current short-term ECAI issue specific rating assigned to a claim on it by another person (including another authorized institution); and

(ii) if *subrules (6)* and *(7)* applied to the claim referred to in *subparagraph (i)*, it would be allocated a risk-weight of 150% pursuant to those subrules,

then the institution shall allocate a risk-weight of 150% to each other claim by it on the corporate which does not have a current ECAI issue specific rating.

(9) Where -

(a) pursuant to *subrules (6)* and *(7)* an authorized institution allocates a risk-weight of 50% or 100% to a claim by it on a corporate; or

(b) the institution knows that -

(i) the corporate has a current short-term ECAI issue specific rating assigned to a claim on it by another person (including another authorized institution); and

(ii) if *subrules (6)* and *(7)* applied to the claim referred to in *subparagraph (i)*, it would be allocated a risk-weight of 50% or 100% pursuant to those subrules,

then the institution shall not allocate a risk-weight of less than 100% to each other claim -

(c) by it on the corporate;

(d) which does not have a current short-term ECAI issue specific rating; and

(e) with an original maturity not greater than that of the claim referred to in *paragraph (a)* or *(b)(i)*, whichever is the greater.

17. 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;

(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 *rules 10* to *16*, *18* and *20.*

18. Regulatory retail exposures

(1) Subject to *subrule (2)*, an authorized institution shall allocate a risk-weight of 75% to each of its regulatory retail exposures.

(2) Where a regulatory retail exposure of an authorized institution is a claim on a small business, the institution shall comply with -

(a) the provisions applicable to authorized institutions in the Commercial Credit Reference Agency framework set out in the Monetary Authority's Supervisory Policy Manual Module IC-7 entitled "The Sharing and Use of Commercial Credit Data through a Commercial Credit Reference Agency", as that framework is in force from time to time; and

(b) the provisions of any guidelines relating to that framework issued by -

(i) the Monetary Authority;

(ii) the Hong Kong Association of Banks; or

(iii) the DTC Association.

19. Residential mortgage loans

(1) Subject to *subrules (2)* and *(5)*, an authorized institution shall allocate a risk-weight of 35% to a residential mortgage loan where -

(a) the borrower under the loan is -

(i) a natural person or persons; 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) subject to *subrule (3)*, the loan-to-value ratio of the loan, if each residential property falling within *paragraph (b)* is situated in Hong Kong, does not exceed 70% 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;

(e) the loan-to-value ratio of the loan, if each residential property falling within *paragraph (b)* is situated in Hong Kong, does not exceed 100% of the current open market value of the property the

subject of the loan after the time the loan was drawn by the borrower or purchased by the institution; and

(f) 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 *subrule (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) Where -

(a) a residential mortgage loan is made by an authorized institution to a member of its staff (whether solely or jointly with another person); and

(b) each residential property falling within *subrule (1)(b)* in respect of the loan is situated in Hong Kong,

then the loan-to-value ratio of the loan shall not exceed 90% at the time a commitment to extend the loan was created by the institution.

(4) Subject to *subrule (5)*, an authorized institution shall allocate a risk-weight of -

(a) subject to *subrule (8)*, 75% to a residential mortgage loan made or purchased by it which does not fall within *subrule (1)* but -

(i) does satisfy *paragraph (a)(i)* and *(iii)* of the definition of "regulatory retail exposure"; and

(ii) the loan-to-value ratio of which 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;

(b) 100% to a residential mortgage loan made or purchased by it which does not fall within *subrule (1)* or *paragraph (a)*.

(5) Subject to *subrule (6)*, an authorized institution shall exclude from the calculation of the loan-to-value ratio of a residential mortgage loan made or purchased by it -

(a) 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; and

(b) any portion of the loan amount the subject of -

(i) a guarantee given by a person referred to in *rule 54*;

(ii) insurance given by an insurer eligible for a risk-weight of not more than 20% in the use of the STC to calculate credit risk; or

(iii) cash on deposit falling within *rule 34(1)(a)*.

(6) 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 *subrule (5)*.

(7) An authorized institution given a notice under *subrule (6)* shall comply with the notice.

(8) *Subrule (4)(a)* shall not apply to a residential mortgage loan made or purchased by an authorized institution if the application of that subrule to the loan would cause the institution's maximum aggregate retail exposure referred to in *paragraph (a)(iii)* of the definition of "regulatory retail exposure" to exceed HK $10 million.

(9) In this rule -

"loan-to-value ratio" ( ), in relation to a residential mortgage loan, means the ratio of the amount of -

(a) that loan; and

(b) all other loans in respect of which the residential property falling within *subrule (1)(b)* in respect of that loan is also used as security,

to the market value of the security.

20. Other assets which are not past due exposures

(1) This rule applies to each on-balance sheet asset of an authorized institution which -

(a) does not fall within any of *rules 10* to *19* or *21* (including accrued interest if *subrule (5*) is applicable); and

(b) is not excluded for the purposes of this Part by *rule 8(a)*.

(2) Subject to *subrules (3)* and *(4)*, an authorized institution shall allocate a risk-weight of 100% to an asset to which this rule 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 rule applies, a risk-weight specified in the notice, being a risk-weight greater than 100%.

(4) An authorized institution given a notice under *subrule (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 rule applies.

21. Past due exposures

(1) Notwithstanding *rules 10* to *20,* an authorized institution shall allocate a risk-weight of 150% to the relevant amount of a past due exposure.

(2) In this rule, “relevant amount” ( ), in relation to a past due exposure, means the amount -

(a) representing the unsecured portion of the exposure; and

(b) calculated by deducting from the gross outstanding amount of the exposure -

(i) the value of any specific provisions made in respect of the exposure; and

(ii) the sum representing the effect of any recognised credit risk mitigation on the exposure.

22. Application of current ECAI ratings

(1) An authorized institution shall, in performing its function under any subrule of *rule 10, 12, 14, 15* or *16* in relation to a claim of the institution consisting of a debt obligation issued or undertaken by any person ("concerned claim A") where the debt obligation has one or more than one current ECAI issue specific rating assigned to it, determine the rating to be used in accordance with *subrule (2)*.

(2) An authorized institution shall, in performing its function under *subrule (1)* in relation to concerned claim A -

(a) if the claim has only one applicable current ECAI issue specific rating, use that rating;

(b) if the claim has 2 applicable current ECAI issue specific ratings the use of which by the institution would result in the allocation by the institution of different risk-weights to the claim, use that one of those ratings which would result in the allocation by the institution of the higher of those different risk-weights;

(c) if the exposure has 3 or more applicable current ECAI issue specific ratings the use of which by the institution would result in the allocation by the institution of different risk-weights to the claim, use that one of those ratings which would result in the allocation by the institution of the second lowest of those different risk-weights.

(3) Subject to *subrules (4A)* and *(6)*, where -

(a) a claim (howsoever described) of an authorized institution falling within any subrule of *rule 10, 12, 14, 15* or *16* does not have a current ECAI issue specific rating;

(b) the person against whom the institution has the claim has a current long-term ECAI issue specific rating assigned to a debt obligation issued or undertaken by the person; and

(c) the person against whom the institution has a claim does not have a current ECAI issuer rating,

then the institution shall, in performing its function under that subrule in relation to that exposure, use the current long-term ECAI issue specific rating referred to in *paragraph (b)* in relation to the exposure subject to the condition that, if the use of that current long-term ECAI issue specific rating by the institution would result in the allocation by the institution of a risk-weight to the exposure which would be lower than the risk-weight allocated by the institution to the exposure on the basis that the person has neither a current ECAI issuer rating nor a current ECAI issue specific rating assigned to a debt obligation issued or undertaken by it, then the exposure must rank *pari passu* with, or senior in respect of payment or repayment to, the debt obligation referred to in *paragraph (b)*.

(4) Subject to *subrules (4A)* and *(6)*, where -

(a) a claim (howsoever described) of an authorized institution falling within any subrule of *rule 10, 12, 14, 15* or *16* does not have a current ECAI issue specific rating;

(b) the person against whom the institution has the claim has a current ECAI issuer rating; and

(c) the person against whom the institution has the claim does not have a long-term ECAI issue specific rating assigned to a debt obligation issued or undertaken by the person,

then the institution shall, in performing its function under that subrule in relation to that claim, use the current ECAI issuer rating referred to in *paragraph (b)* in relation to the exposure subject to the condition that, if the use of that current ECAI issuer rating by the institution would result in the allocation by the institution of a risk-weight to the exposure which would be lower than the risk-weight allocated by the institution to the exposure on the basis that the person has neither a current ECAI issuer rating nor a current ECAI issue specific rating assigned to a debt obligation issued or undertaken by it, then -

(d) the parameters of that current ECAI issuer rating must not indicate that the rating should be treated as any thing other than a rating applicable to senior, unsecured claims on the person as an issuer; and

(e) the claim on the person must be senior and unsecured.

(4A) An authorized institution shall, in determining pursuant to *subrule (3)* or *(4)* the risk-weight for a claim falling within *paragraph (a)* of that subrule ("concerned claim B") based on one or more than one current ECAI issue specific rating of another debt obligation issued or undertaken by the person against whom the institution has concerned claim B ("reference claim"), or based on one or more than one current ECAI issuer rating of that person ("issuer") -

(a) if the reference claim has only one applicable current ECAI issue specific rating, or the issuer has only one applicable current ECAI issuer rating, as the case may be, use that rating;

(b) if the reference claim has 2 applicable current ECAI issue specific ratings, or the issuer has 2 applicable current ECAI issuer ratings, as the case may be, the use of which by the institution would result in the allocation by the institution of different risk-weights to concerned claim B, use that one of those ratings which would result in the allocation by the institution of the higher of those different risk-weights;

(c) if the reference claim has 3 or more current ECAI issue specific ratings, or the issuer has 3 or more current ECAI issuer ratings, as the case may be, the use of which by the institution would result in the allocation by the institution of different risk-weights to concerned claim B, use that one of those ratings which would result in the allocation by the institution of the second lowest of those different risk-weights.

(5) Subject to *subrules (5A)* and *(6)*, where -

(a) a claim (howsoever described) of an authorized institution falling within any subrule of any rule of this Part does not have a current ECAI issue specific rating;

(b) the person against whom the institution has the claim has -

(i) a current ECAI issuer rating; and

(ii) a current long-term ECAI issue specific rating assigned to a debt obligation issued or undertaken by the person; and

(c) the use, in accordance with *subrule (3)* or *(4)*, of the current ECAI issuer rating and the current ECAI issue specific rating referred to in *paragraph (b)* by the institution would result in the allocation by the institution of 2 different risk-weights to the claim,

then the institution, in performing its function under that subrule in relation to that exposure, may allocate the lower of the 2 risk-weights to the claim.

(5A) An authorized institution -

(a) shall, in determining pursuant to *subrule (5)* the risk-weight for a claim falling within *paragraph (a)* of that subrule ("concerned claim C") based on one or more than one current ECAI issue specific rating of another debt obligation issued or undertaken by the person against whom the institution has concerned claim C ("reference claim"), and one or more than one current ECAI issuer rating of that person -

(i) apply *subrule (4A)* to the one, or more than one, as the case may be, current ECAI issue specific rating to determine the issue specific rating to be used; and

(ii) apply *subrule (4A)* to the one, or more than one, current ECAI issuer rating to determine the issuer rating to be used; and

(b) may, if the risk-weight allocated by the institution to the issue specific rating determined pursuant to *paragraph (a)(i)* is different from the risk-weight allocated by the institution to the issuer rating determined pursuant to *paragraph (a)(ii)*, allocate the lower of the 2 risk-weights to concerned claim C.

(6) The operation of *subrules (3)*, *(4), (4A), (5)* and *(5A)* shall be subject to the operation of *rules 14(10)* and *(11)*, *15(8)* and *(9)* and *16(8)* and *(9)* and the operation of *subrules (1)* and *(2)* shall be subject to the operation of *rule 14(11)*.

(7) Where an authorized institution allocates a risk-weight to an exposure of the institution pursuant to *subrule (3), (4), (4A), (5)* or *(5A)*, then -

(a) subject to *paragraph (b)*, the institution shall -

(i) use current ECAI ratings applicable to foreign currency, if available, to the extent that the exposure is denominated in foreign currency; and

(ii) use current ECAI ratings applicable to domestic currency, if available, to the extent that the exposure is denominated in domestic currency;

(b) the institution may use the counterparty's current ECAI rating applicable to the counterparty's domestic currency, if available, for the purpose of risk-weighting -

(i) an exposure arising pursuant to the institution's participation in a loan made by a multilateral development bank which is denominated in another currency; or

(ii) an exposure denominated in another currency to the extent that the exposure is guaranteed by a multilateral development bank against convertibility and transfer risk.

22A. Authorized institutions must nominate ECAIs to be used

(1) Notwithstanding any other provision of this Part (including *rule 22*) but subject to *subrule (2)*, an authorized institution shall -

(a) before or on the date of the commencement of this rule; or

(b) before or on the date on which it becomes an authorized institution incorporated in Hong Kong,

whichever is the later -

(c) nominate, for each of its ECAI ratings based portfolios not falling within *paragraph (d)*, the name of the ECAI the credit assessment ratings of which it will use, for the purposes of this Division, in respect of the ECAI ratings based portfolio concerned; or

(d) nominate, for each of its ECAI ratings based portfolios not falling within *paragraph (c)*, the names of the ECAIs the credit assessment ratings of which it will use, for the purposes of this Division, in respect of the ECAI ratings based portfolio concerned.

(2) An authorized institution -

(a) shall nominate under *subrule (1)(c)* the name of an ECAI in respect of an ECAI ratings based portfolio of the institution in respect of which, having regard to the counterparties to the institution's claims falling within that portfolio and to the geographical regions where those claims arise or may require to be enforced, it can reasonably be concluded that the ECAI so

nominated issues a range of credit assessment ratings which provides a reasonable coverage for that portfolio;

(b) shall nominate under *subrule (1)(d)* the names of ECAIs in respect of an ECAI ratings based portfolio of the institution in respect of which, having regard to the counterparties to the institution's claims falling within that portfolio and to the geographical regions where those claims arise or may require to be enforced, it can reasonably be concluded that the ECAIs so nominated, and taken collectively, issue a range of credit assessment ratings which provides a reasonable coverage for that portfolio.

(3) An authorized institution shall, as soon as is practicable after making a nomination under *subrule (1)*, give notice in writing to the Monetary Authority of the nomination.

(4) An authorized institution shall not, in respect of an ECAI ratings based portfolio of the institution, use, for the purposes of this Division, the credit assessment ratings of an ECAI unless -

(a) the ECAI has been nominated under *subrule (1)* in respect of that portfolio; and

(b) notice of that nomination has been given to the Monetary Authority pursuant to *subrule (3)*.

(5) An authorized institution may, with the prior consent of the Monetary Authority, amend a nomination under *subrule (1)* (including a nomination amended pursuant to this subrule).

(6) *Subrules (2)*, *(3)* and *(4)* shall, with all necessary modifications, apply to a nomination to be amended, or amended, pursuant to *subrule (5)* as they apply to a nomination under *subrule (1)*.

(7) For the avoidance of doubt, it is hereby declared that an authorized institution shall, for the purposes of this Division, treat as not having an ECAI rating any person, or debt obligation, which, although falling within an ECAI ratings based portfolio of the institution, does not have a current ECAI rating assigned to it by an ECAI nominated under *subrule (1)* by that institution in respect of that portfolio.

(8) In this rule -

"authorized institution" ( ) includes (except in *subrules (4)* and *(7)*) a company incorporated in Hong Kong by or under the Companies Ordinance (Cap. 32) or any other Ordinance which has made an application under section 15 of the Ordinance for authorization;

"ECAI ratings based portfolio" ( ), in relation to an authorized institution, means -

(a) the institution's claims on sovereigns;

(b) the institution's claims on banks;

(c) the institution's claims on securities firms; or

(d) the institution's claims on corporates.

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 8*; 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 8* opposite the exposure.

Table 8

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 8 – continued

7.	Forward forward deposits placed	100%
8.	Note issuance and revolving underwriting facilities	50%
9.	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 *Table 9* - (a) commitments with an original maturity of up to and including one year; (b) commitments with an original maturity of over one year; (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 creditworthiness, where: "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	 (a) 20% (b) 50% (c) 0%

Table 8 - continued

institution and the earliest date on which the institution can, at its option, unconditionally cancel the exposure.	

(2) Subject to *rule 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 9*; 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 9* 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 9* 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 9* 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 9

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

Column 1	Column 2
Off-balance sheet exposures	Credit conversion factor
1. Exchange rate contracts (other than an excluded exchange rate contract) -	
(a) with a residual maturity of up to and including one year;	1%
(b) with a residual maturity of over one year up to and including 5 years;	5%
(c) with a residual maturity of over 5 years,	7.5%
where:	
"excluded exchange rate contract" ( ) means –	
(a) an exchange rate contract which has an original maturity of not more than 14 calendar days; or	
(b) a forward exchange rate contract;	

Table 9 - continued

“forward exchange rate contract” ( ), means a contract entered into by the authorized institution pursuant to a swap deposit arrangement with a counterparty to repurchase foreign currency, which has been deposited by the counterparty with the institution, against another currency at a predetermined exchange rate on a future date; “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 predetermined exchange rate on a future date.	

Table 9 - continued

2.	Interest rate contracts -		
	(a)	with a residual maturity of up to and including one year;	0%
	(b)	with a residual maturity of over one year up to and including 5 years;	0.5%
	(c)	with a residual maturity of over 5 years.	1.5%
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%

Table 9 - continued

5. Other commodities contracts - (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.	 10% 12% 15%
6. Credit derivative contracts consisting of - (a) credit default swaps booked in the trading book - (i) where the authorized institution is a protection buyer and the underlying reference [obligation] is - (A) a qualifying reference [obligation]; (B) a non-qualifying reference [obligation]; (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 potential exposure is	 5% 10%

Table 9 - continued

capped at the amount of the unpaid premium under the contract provided that the underlying reference [obligation] is -	
(A) a qualifying reference [obligation];	5%
(B) a non-qualifying reference [obligation];	10%
(b) total return swaps booked in the trading book -	
(i) where the authorized institution is the total return receiver and the underlying reference [obligation] is -	
(A) a qualifying reference [obligation];	5%
(B) a non-qualifying reference [obligation];	10%
(ii) where the authorized institution is the total return payer and the underlying reference [obligation] is-	
(A) a qualifying reference [obligation];	5%
(B) a non-qualifying reference [obligation].	10%

24. Provisions supplementary to *rule 23*

For the purposes of the operation of *rule 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 rule 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 of which 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 [entities] if there is at least one non-qualifying reference entity in the basket of reference [entities], otherwise the credit conversion factor of the qualifying reference [entities] 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 [entities] if there are at least 2 non-qualifying reference [entities] in the basket of reference [entities] of the second-to-default credit derivative contract, otherwise the credit conversion factor of the qualifying reference [entities] 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 [entities] 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 8* or *9*

(1) An authorized institution shall calculate the credit equivalent amount of an off-balance sheet exposure which is not specified in *Table 8* or *Table 9* 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 credit conversion factor applicable to the exposure as specified in a notice under *subrule (2)*.

(2) The Monetary Authority may, by notice published in the Gazette, specify a credit conversion factor applicable to an off-balance sheet exposure referred to in *subrule (1)*.

(3) For the avoidance of doubt, it is hereby declared that a notice under *subrule (2)* is not subsidiary legislation.

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

(1) Subject to *subrule (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 *rules 10* to *21*.

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

(a) an assets 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 *subrule (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 *subrule (2)(d)* of an authorized institution is -

(a) a first-to-default credit derivative contract -

(i) which has a current ECAI issue specific rating, then the institution shall allocate to the contract the risk-weight applicable as derived from the risk-weight applied to asset securitisation;

(ii) which does not have a current ECAI issue specific rating, then the institution -

(A) subject to *sub-subparagraph (B)*, shall aggregate the risk-weights of the reference [entities] in the basket of reference [entities] specified in the contract to determine the risk-weight of the contract; and

(B) shall not allocate to the contract a risk-weight greater than 1250%;

(b) a second-to-default credit derivative contract -

(i) which has a current ECAI issue specific rating, then the institution shall allocate to the contract the risk-weight applicable as derived from the risk-weight applied to asset securitisation;

(ii) which does not have a current ECAI issue specific rating, then the institution -

(A) subject to *sub-subparagraph (B)*, shall aggregate the risk-weights of the reference [entities] in the basket of reference [entities] specified in the

contract to determine the risk-weight of the contract but excluding the lowest of those risk-weights; and

(B) shall not allocate to the contract a risk-weight greater than 1250%;

(c) 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 1*.

(4) For the avoidance of doubt, it is hereby declared that where an off-balance sheet exposure referred to in *subrule (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 *rule 19* to the exposure if the institution has no reason to believe that any of the provisions of that rule will not be satisfied immediately after the loan that is the subject of that commitment is drawn down.

Formula 1

Calculation of risk-weighted exposure of credit derivative contract falling within *rule 26(3)(c)*

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

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].

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

An authorized institution shall calculate its total aggregate risk-weighted 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 *rules 10* to *21*; and

(b) subject to *rule 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 9*, deducting any specific provisions applicable to such exposures) by the risk-weights respectively allocated to the counterparties to the exposures under *rules 10* to *21*.

[**28. Provision not used].**

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

An authorized institution shall calculate the risk-weighted exposure 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 exposure 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 funds 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 exposure of the transaction by reference to the risk-weight attributable to the counterparty subject to the application of any recognised credit risk mitigation in respect of collateralised 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 funds 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 exposure of the transaction by reference to the risk-weight attributable to the counterparty subject to the application of any recognised credit risk mitigation in respect of collateralised 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 exposure of the transaction by reference to the risk-weight attributable to the securities.

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

An authorized institution shall calculate the risk-weighted exposure 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 *rule 29(a)* or *(c)(ii)* if it were booked in the institution's banking book;

(b) the application of the comprehensive approach to the treatment of collateral in any case where the transaction would fall within *rule 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 which is collateral

Collateral is recognised 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 the counterparty (and, where applicable, of the custodian 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;

(g) if the simple approach to the treatment of collateral applies to the collateral, the collateral -

  (i) is pledged for not less than the life of the exposure;

  (ii) subject to *subparagraph (iii)*, is re-valued not less than every 6 months from the date upon which the collateral is taken in respect of the exposure; and

  (iii) in the case of an exposure which is a past due exposure, is re-valued not less than every 3 months from the date upon which the exposure is categorised as a past due exposure;

(h) if the simple approach to the treatment of collateral applies to the collateral, the institution may, in the case of a past due exposure,

take into account collateral in the form of real property (whether residential or otherwise) the value of which is subject to re-valuation not less than every 3 months from the date upon which the exposure is categorised as a past due exposure; and

(i) if the comprehensive approach to the treatment of collateral applies to the collateral, the institution has in place a written internal policy and systems and procedures -

(i) adequate to enable the institution to manage collateral provided to it in respect of any relevant exposure; and

(ii) to revalue the collateral as necessary and take account of the assumed minimum holding periods for collateral in the calculation of risk-weighted assets and risk-weighted exposures for collateralised transactions.

33. Capital treatment of recognised collateral

(1) Subject to *subrule (2)*, an authorized institution may adopt the simple approach or the comprehensive approach in respect of the treatment of recognised collateral.

(2) An authorized institution shall -

(a) for all exposures in the institution's banking book which are not past due exposures, adopt only the simple approach or only the comprehensive approach in respect of the treatment of recognised collateral;

(b) for a past due exposure in the institution's banking book, adopt only the simple approach in respect of the treatment of recognised collateral; and

(c) for an exposure in the institution's trading book, adopt only the comprehensive approach in respect of the treatment of recognised collateral.

34. Recognised collateral under simple approach

(1) Where an authorized institution adopts the simple approach to the treatment of collateral, only the following recognised collateral may be used under that approach -

(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 against exposures in its banking book;

(c) cash-funded credit-linked notes -

(i) which fulfil requirements for credit derivative contracts specified in *rule 55* (except that the notes do not have to fulfil the requirements of *rule 55(1)(a)* or those requirements of *rule 55* that only apply to credit default swaps and total return swaps); and

(ii) issued by the institution against exposures in its banking book;

(d) instruments issued by the institution which are comparable to instruments referred to in *paragraph (b)* or *(c)*;

(e) gold;

(f) debt securities issued by a sovereign that have a current ECAI issue specific rating which, if mapped to the scale of credit quality grades in *Table A* set out in *Schedule 2*, would result in the debt securities being assigned a credit quality grade of not more than 4;

(g) subject to *subrule (2)*, debt securities issued by a sovereign foreign public sector entity which have a current ECAI issue specific rating which, if mapped to the scale of credit quality grades in *Table A* set out in *Schedule 2*, would result in the debt securities being assigned a credit quality grade of not more than 4;

(h) debt securities issued by a domestic public sector entity, or a foreign public sector entity which is not a sovereign foreign public sector entity, that have a current ECAI issue specific rating which, if mapped to the scale of credit quality grades in *Table A* set out in *Schedule 2*, would result in the debt securities being assigned a credit quality grade of not more than 3;

(i) debt securities issued by a multilateral development bank;

(j) debt securities issued by a bank or securities firm which have a current ECAI issue specific rating which, if mapped to the scale of credit quality grades in *Table B* set out in *Schedule 2*, would result in the debt securities being assigned a credit quality grade of not more than 3;

(k) debt securities issued by a corporate which have a current ECAI issue specific rating which, if mapped to the scale of credit quality grades in *Table C* set out in *Schedule 2*, would result in the debt securities being assigned a credit quality grade of not more than 3;

(l) debt securities issued by a bank, securities firm or corporate which have a current short-term ECAI issue specific rating which, if

mapped to the scale of credit quality grades in *Table D* set out in *Schedule 2*, would result in the debt securities being assigned a credit quality grade of not more than 3;

(m) debt securities issued by a bank or securities firm which do not have a current ECAI issue specific rating where -

(i) the debt securities rank as senior debt of the issuer of the debt securities;

(ii) the debt securities are listed on a recognised exchange and the institution is of the reasonable opinion that, having regard to current market conditions, there is sufficient liquidity in the market for the debt securities to enable the institution to dispose of the debt securities at an open market price;

(iii) other issues of debt securities issued by the same issuer, and which rank pari passu with the first-mentioned debt securities, have a current ECAI issue specific rating which, if mapped to the scale of credit quality grades in *Table B* set out in *Schedule 2* (or, in the case of claims with current short-term ECAI issue specific ratings, in *Table D* set out in *Schedule 2*) would result in the debt securities being assigned a credit quality grade of not more than 3; and

(iv) the institution is not aware, and has no reason to be aware, of information suggesting that an assignment of a credit

quality grade of higher than 3 would be justified in respect of the debt securities;

(n) equities (including convertible bonds) that are included in any main indices;

(o) units or shares in a collective investment scheme where -

(i) the price of the units or shares in that scheme is quoted publicly on a daily basis; and

(ii) that scheme is restricted by its investment guidelines or objects to investing in those items listed in these Rules as being recognised collateral for the purposes of adopting the simple approach to the treatment of collateral; and

(p) collateral in the form of real property (whether residential or otherwise) insofar as the collateral relates to a past due exposure.

(2) The Monetary Authority may, by notice published in the Gazette, specify debt securities, or debt securities belonging to a class of debt securities, which do not fall within *subrule (1)(g)*.

(3) For the avoidance of doubt, it is hereby declared that a notice under *subrule (2)* is not subsidiary legislation.

35. Recognised collateral under comprehensive approach

Where an authorized institution adopts the comprehensive approach to the treatment of collateral, only the following recognised collateral may be used under that approach -

(a) collateral falling within *rule 34*;

(b) equities (including convertible bonds) which are not included in a main index but are listed on a recognised exchange;

(c) collective investment schemes which may invest in equities referred to in *paragraph (b)*; and

(d) assets received by the institution under a transaction -

 (i) falling within *paragraph (c)* or *(d)* of the definition of "repo-style transaction"; and

 (ii) booked in the institution's trading book.

Division 6A – Provisions applicable to credit risk mitigation under simple approach to treatment of collateral

36. Calculation of risk-weighted assets and risk-weighted exposures taking into account recognised credit risk mitigation effect of simple approach to treatment of collateral

(1) Where an authorized institution adopts the simple approach to the treatment of collateral, then the institution shall, in respect of an on-balance sheet asset or off-balance sheet exposure of the institution to which the recognised collateral relates -

(a) subject to *paragraphs (b)* and *(c)* and *subrule (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 *rule 34(1)(a), (b), (c) 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 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");

(c) allocate a risk-weight of 100% to the credit protection covered portion of the on-balance sheet asset or off-balance sheet exposure, as the case may be, if -

(i) the asset or exposure, as the case may be, is a past due exposure; and

(ii) the collateral provided in respect thereof is real property;

(d) 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 -

(i) subject to *subparagraph (ii)*, the risk-weight of the counterparty;

(ii) in the case of a past due exposure, a risk-weight of 150%.

(2) An authorized institution shall, for the purposes of making a substitution pursuant to *subrule (1)(a)* where the collateral concerned is real property, reduce the value of the real property by –

(a) 10% in the case of residential property;

(b) 20% in the case of any other real property.

37. Determination of risk-weight to be allocated to recognised collateral under simple approach to treatment of collateral

(1) Where an authorized institution adopts the simple approach to the treatment of collateral, then the institution -

(a) subject to *paragraph (b)*, shall determine the risk-weight to be allocated to the recognised collateral in accordance with *rules 10* to *21*; and

(b) subject to *subrules (2), (3)* and *(4)*, shall not allocate a risk-weight of less than 20% to the recognised collateral.

(2) Subject to *subrule (3)*, an authorized institution may under *subrule (1)* allocate a risk-weight of 0% to recognised collateral provided under a repo-style transaction in the institution's banking book falling within *paragraph (c)* or *(d)* of the definition of "repo-style transaction" where -

(a) the counterparty ("core market participant") is -

(i) a sovereign;

(ii) a public sector entity;

(iii) a multilateral development bank;

(iv) a bank or securities firm;

(v) a corporate which is a financial institution (other than a bank or securities firm) eligible for a risk-weight of 20% in the use of STC to calculate credit risk; or

[(vi) a recognised clearing organisation;]

(b) the exposure to which the collateral relates and the collateral are -

(i) cash; or

(ii) securities issued by a sovereign, or a sovereign foreign public sector entity, which would be allocated a risk-weight of 0% in the use of STC to calculate credit risk;

(c) the exposure and the collateral are denominated in the same currency;

(d) either -

(i) the exposure is only an overnight exposure; or

(ii) the exposure and the collateral are re-valued daily by marking-to-market and the value of any excess collateral ("margin") is subject to daily adjustment based upon the value of the exposure and the collateral;

(e) the institution reasonably expects, if the counterparty fails to deliver any margin required to be delivered to the institution under the terms of the transaction, to be able to liquidate the collateral for its benefit within 4 business days of the date upon which the exposure and collateral were last marked-to-market prior to the counterparty's failure to deliver the margin;

(f) the transaction is settled by means of a settlement system customarily used for repo-style transactions;

(g) the transaction is documented using standard market documentation for the securities which are the subject matter of the transaction; and

(h) the documentation setting out the transaction provides that the institution -

(A) may terminate the transaction immediately if-

(I) the counterparty commits an event of default under the transaction; or

(II) an event of default occurs in respect of the counterparty; and

(B) has, immediately upon any such default, an unfettered and legally enforceable right to seize and liquidate the collateral for its benefit and whether or not the counterparty is insolvent or bankrupt.

(3) Where the recognised collateral provided to an authorized institution under a repo-style transaction which satisfies all the provisions of *subrule (2)* except *paragraph (a)* of that subrule, then the institution may under *subrule (1)* allocate a risk-weight of 10% to the collateral.

(4) An authorized institution may under *subrule (1)* allocate a risk-weight of -

(a) 0% to recognised collateral provided under an OTC derivative transaction where -

(i) the transaction is marked-to-market daily and is collateralised by cash provided to the institution; and

(ii) the settlement currency of the transaction is the same currency as the cash provided to the institution as collateral;

(b) 10% to recognised collateral which is provided under an OTC derivative transaction where the collateral provided to the institution is debt securities issued by a sovereign, or a sovereign foreign public sector entity, which would under *rule 10* or *12*, as the case may be, be allocated a risk-weight of 0%;

(c) 0% to recognised collateral which falls within *paragraph (c)* of the definition of "cash items";

(d) 0% to recognised collateral provided in the case of any financial transaction where the collateral is -

  (i) denominated in the same currency as the exposure to which the collateral relates; and

  (ii) either -

    (A) cash on deposit with the institution; or

    (B) debt securities -

      (I) issued by a sovereign, or sovereign foreign public sector entity, which would under *rule 10* or *12*, as the case may be, be allocated a risk-weight of 0%; and

      (II) the current market value of which has been reduced by a haircut of 20%.

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 recognised 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. 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 recognised 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. 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 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 – Provisions applicable to credit risk mitigation under comprehensive approach to treatment of collateral

41. Calculation of risk-weighted assets and risk-weighted exposures taking into account recognised credit risk mitigation effect of comprehensive approach to treatment of collateral

Where an authorized institution adopts the comprehensive approach to the treatment of collateral, then the institution shall calculate the risk-weighted amount of its on-balance sheet assets and off-balance sheet exposures in accordance with *rules 42* to *48*.

42. On-balance sheet assets

An authorized institution shall calculate its net credit exposure to a counterparty in respect of an on-balance sheet asset by the use of *Formula 2*.

Formula 2

Calculation of net credit exposure to counterparty under on-balance sheet asset

$E^* = \max \{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\}$

where:

E^* = net credit exposure;

E = principal amount of on-balance sheet asset net of specific provisions, if any;

H_e = haircut applicable to the authorized institution's exposure to the counterparty pursuant to the standard supervisory haircuts for the comprehensive approach to treatment of collateral subject to adjustment as set out in *rule 47*;

C = value of the recognised collateral before adjustment required by the comprehensive approach to treatment of collateral;

H_c = haircut applicable to the recognised collateral pursuant to the standard supervisory haircuts for the comprehensive approach to treatment of collateral subject to adjustment as set out in *rule 47*; and

H_{fx} = haircut applicable in consequence of a currency mismatch, if any, between the on-balance sheet asset and the recognised collateral subject to adjustment as set out in *rule 47*.

43. Off-balance sheet exposures other than credit derivative contracts booked in trading book or OTC derivative transactions

An authorized institution shall calculate its net credit exposure to a counterparty in respect of an off-balance sheet exposure (other than a credit derivative contract booked in the trading book of the institution or an OTC derivative transaction) by the use of *Formula 3*.

Formula 3

Calculation of net credit exposure to counterparty under off-balance sheet exposures other than credit derivative contracts booked in the trading book and OTC derivative transactions

$E^* = \max \{0, [E \times (1 + H_e) – C \times (1 - H_c - H_{fx})]\} \times CCF$

where:

E^* = net credit exposure;

E = principal amount of off-balance sheet exposure net of specific provisions, if any;

H_e = haircut applicable to the authorized institution's exposure to the counterparty pursuant to the standard supervisory haircuts for the comprehensive approach to the treatment of collateral subject to adjustment as set out in *rule 47*;

C = value of the recognised collateral before adjustment required by the comprehensive approach to the treatment of collateral;

H_c = haircut applicable to the collateral pursuant to the standard supervisory haircuts for the comprehensive approach to the treatment of collateral subject to adjustment as set out in *rule 47*;

H_{fx} = haircut applicable in consequence of a currency mismatch, if any, between the off-balance sheet exposure and the recognised collateral subject to adjustment as set out in *rule 47*; and

CCF = credit conversion factor applicable to the off-balance sheet exposure.

44. Credit derivative contracts booked in trading book and OTC derivative transactions

An authorized institution shall calculate its net credit exposure to a counterparty in respect of a credit derivative contract booked in the institution's trading book, or an OTC derivative transaction, by the use of *Formula 4*.

Formula 4

Calculation of net credit exposure to counterparty under credit derivative contracts booked in trading book and OTC derivative transactions

$E^* = \max\{0, [E \times (1 + H_e) – C \times (1 - H_c - H_{fx})]\}$

where:

E^* = net credit exposure;

E = credit equivalent amount of the exposure (calculated by aggregating the potential exposure and current exposure of the authorized institution in relation to the credit derivative contract or OTC derivative transaction, as the case may be) net of specific provisions, if any;

H_e = haircut applicable to the authorized institution's exposure to the counterparty pursuant to the standard supervisory haircuts for the comprehensive approach to the treatment of collateral subject to adjustment as set out in *rule 47*;

C = value of the recognised collateral before adjustment required by the comprehensive approach to the treatment of collateral;

H_c = haircut applicable to the collateral pursuant to the standard supervisory haircuts for the comprehensive approach to the treatment of collateral subject to adjustment as set out in *rule 47*; and

H_{fx} = haircut applicable in consequence of a currency mismatch, if any, between the off-balance sheet exposure and the recognised collateral subject to adjustment as set out in *rule 47*.

45. Haircuts

Where more than one type of recognised collateral is provided to an authorized institution in respect of an exposure of the institution to an on-balance sheet asset or off-balance sheet exposure of the institution, then the institution shall calculate the haircuts applicable to the collateral by the use of *Formula 5*.

Formula 5

Calculation of haircuts where more than one type of recognised collateral is provided in respect of the same exposure

$$H_a = \sum_i a_i \times H_i$$

where:

H_a = haircuts applicable to the recognised collateral;

a_i = weight of a given type of recognised collateral provided in respect of the exposure in relation to the aggregate value of all types of recognised collateral provided in respect of that exposure; and

H_i = haircut applicable to that given type of recognised collateral subject to adjustment as set out in *rule 47*.

46. Minimum holding periods

Where in respect of an exposure of an authorized institution to an on-balance sheet asset or off-balance sheet exposure of the institution, there is -

(a) a daily re-valuation of the exposure and the recognised collateral provided in respect of the exposure; or

(b) a daily adjustment of the margin of the recognised collateral provided in respect of the exposure,

then the institution shall take the assumed minimum holding periods to be as set out in *Table 10.*

Table 10

Assumed minimum holding periods

Type of transaction	Assumed minimum holding period	Condition
Repo-style transactions	5 business days	Daily remargining
Other capital market transactions	10 business days	Daily remargining
Secured lending transactions	20 business days	Daily revaluation

47. Adjustment of standard supervisory haircuts in certain circumstances

Where for the purposes of *rule 42, 43, 44, 45, 49* or *51* -

(a) the assumed minimum holding period of an on-balance sheet asset or off-balance sheet exposure of an authorized institution is not 10 business days; or

(b) the exposure of an authorized institution to an on-balance sheet asset or off-balance sheet exposure of the institution, and the recognised collateral provided to the institution in respect of the exposure, are not subject to daily remargining or revaluation as assumed in the standard supervisory haircuts,

then the institution shall adjust the standard supervisory haircuts by the use of *Formula 6*.

Formula 6

Adjustment of standard supervisory haircuts for circumstances set out in *rule 47*

$$H = H_{10} \times \sqrt{\frac{N_R + (T_M - 1)}{10}}$$

where:

H = haircut after adjustment for differences in assumed minimum holding period and remargining and revaluation frequency;

H_{10} = standard supervisory haircuts based on an assumed minimum holding period of 10 business days;

T_M = assumed minimum holding period for a particular type of transaction (that is, 5 business days for repo-style transactions or 20 business days for secured lending transactions); and

N_R = actual number of days between each remargining or each revaluation of the recognised collateral.

48. Calculation of risk-weighted amount of collateralised transactions under comprehensive approach to treatment of collateral

An authorized institution shall calculate the risk-weighted amount of each of its on-balance sheet assets and off-balance sheet exposures which is a collateralised transaction by multiplying the net credit exposure of the institution to the counterparty by the risk-weight applicable to the counterparty.

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) Subject to *subrule (3)*, an authorized institution shall calculate its net credit exposure, if any, referred to in *subrule (1)(b)* by the use of *Formula 7*.

Formula 7

Calculation of net credit exposure under valid bilateral netting agreement

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

where:

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

Formula 7 - 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) An authorized institution shall adjust the haircut referred to in *Formula 7* in accordance with *rule 47* if the circumstances specified in that rule apply.

(4) 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 *subrules (2)* to *(3)*, take into account the effect of the netting in calculating its risk-weighted exposure to the counterparty.

(2) Subject to *subrule (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 8*.

Formula 8

Calculation of net potential exposure under nettable derivative transactions

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

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 8* 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 rule -

"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. Netting of repo-style transactions

(1) An authorized institution which has adopted the comprehensive approach to the treatment of collateral shall not take into account valid bilateral netting agreements covering the institution's repo-style transactions in the calculation of its capital adequacy ratio insofar as it relates to credit risk other than in accordance with the provisions of this rule.

(2) Where under nettable repo-style transactions the subject of one valid bilateral netting agreement an authorized institution has the same counterparty, then the institution shall calculate –

(a) the aggregate value of all financial assets sold, transferred, loaned or paid to the counterparty; and

(b) the aggregate value of financial collateral received by the institution consisting of -

(i) in the case of repo-style transactions in the institution's banking book, financial instruments which would be recognised collateral under the comprehensive approach to the treatment of collateral; and

(ii) in the case of repo-style transactions in the institution's trading book, any financial instrument.

(3) Subject to *rule 52*, where, in respect of a calculation under *subrule (2)* made by an authorized institution in respect of a counterparty, the aggregate value referred to in *paragraph (a)* of that subrule is greater than the aggregate value referred to

in *paragraph (b)* of that subrule, then the institution shall calculate its exposure to the counterparty by the use of *Formula 9*.

Formula 9

Calculation of exposure to counterparty where aggregate value referred to in *rule 51(2)(a)* is greater than aggregate value referred to in *rule 51(2)(b)*

$E^{\#}$ = $\text{Max }\{0, [(\Sigma(E) - \Sigma(C)) + \Sigma(E_s \text{ x } H_s) + \Sigma(E_{fx} \text{ x } H_{fx})]\}$

where:

$E^{\#}$ = counterparty exposure after netting;

E = value of financial assets sold, transferred, loaned or paid;

C = value of financial collateral received by the authorized institution;

E_s = absolute value (irrespective of positive or negative) of the net position in the same securities;

H_s = haircut appropriate to the absolute value of the net position in the same securities (that is, E_s) subject to adjustment as set out in *rule 47*;

E_{fx} = absolute value of the net position in a currency different from the settlement currency; and

H_{fx} = haircut applicable in consequence of a currency mismatch, if any, using standard supervisory haircuts subject to adjustment as set out in *rule 47*.

(4) An authorized institution shall allocate to its net exposure to a counterparty, calculated in accordance with *subrule (3)*, the risk-weight attributable to the counterparty.

(5) An authorized institution -

(a) subject to *paragraph (b)*, shall net its nettable repo-style transactions in its banking book separately from netting its nettable repo-style transactions in its trading book and vice versa;

(b) may net repo-style transactions in its banking book with repo-style transactions in its trading book in respect of the same counterparty if -

(i) all those repo-style transactions are marked-to-market daily; and

(ii) all the collateral received by the institution in respect of all those repo-style transactions is recognised collateral under the comprehensive approach to the treatment of collateral.

[52. Use of value-at-risk model instead of *Formula 9*

(1) Where under *Part 6* the Monetary Authority has approved the use by an authorized institution of an internal value-at-risk ("V*a*R") model to measure the institution's exposure to market risk, the institution may, with the approval of the Monetary Authority under *subrule (3)* and in accordance with that approval, adopt a V*a*R model as an alternative to the use of *Formula 9* for the purposes of calculating the institution's exposure to a given counterparty under nettable repo-style transactions the subject of one valid bilateral netting agreement.

(2) An authorized institution referred to in *subrule (1)* may make an application in the specified form to the Monetary Authority for the Monetary Authority's approval to the institution adopting a V*a*R model for the purposes referred to in that rule.

(3) Subject to *subrules (4)* and *(5)*, the Monetary Authority shall determine an application under *subrule (2)* by an authorized institution by notice in writing given to the institution granting, or refusing to grant, the approval sought.

(4) The Monetary Authority shall not grant approval under *subrule (3)* to an authorized institution unless the institution satisfies the Monetary Authority that, in the case of the V*a*R model in respect of which the approval is sought -

(a) the model will take into account any price relationship between the value of financial assets in the form of securities sold, transferred, loaned and paid by the institution and the value of financial collateral received by the institution under nettable repo-style transactions, and, in particular in this regard, whether the prices have a positive relationship (that is, their prices move in the same

direction) negative relationship (that is, their prices move in the opposite direction) or have no relationship at all;

(b) the model will adopt a minimum holding period of 5 days and this minimum holding period will be subject to increase to the extent that the liquidity of the financial instruments provided by way of collateral under the nettable repo-style transactions is such that a longer minimum holding period should be assumed; and

(c) the quality of the model has proved acceptable pursuant to a prescribed demonstration of the model carried out by the institution.

(5) The Monetary Authority shall, in deciding whether or not to grant approval under *subrule (3)* in respect of a V*a*R model, take into account quantitative and qualitative criteria, including criteria similar to those set out in the Monetary Authority's Supervisory Policy Manual module CA-G-3 on Use of Internal Models to Measure Market Risk, as in force from time to time.

(6) Where an authorized institution is granted approval under *subrule (3)* to use a V*a*R model for the purposes referred to in *subrule (1)*, the institution shall calculate its exposure to the counterparty under a nettable repo-style transaction by the use of *Formula 10*.

Formula 10

Calculation of exposure to counterparty under nettable repo-style transaction using V*a*R model

$E^* = \max \{0, [(\Sigma(E) - \Sigma(C)) + VaR \text{ output from internal market risk model x multiplier})]\}$

where:

E^*	=	counterparty exposure after netting;
E	=	current value of exposure;
C	=	value of collateral received by the authorized institution; and
V*a*R output	=	the V*a*R number generated by the V*a*R model in respect of the previous business day subject to adjustment by reference to the relevant multiplier derived as set out in *Table 11*.

(7) In this rule, “prescribed demonstration” ( ), in relation to a V*a*R model proposed to be adopted by an authorized institution for the purposes referred to in *subrule (1)*, means a demonstration –

(a) back-testing the output of the model using a sample of 20 counterparties with data covering a one year period where the counterparties include –

(i) the institution’s 10 largest counterparties as determined by the institution using the usual model of measuring its exposures; and

(ii) 10 counterparties selected at random;

(b) in which for each day and each counterparty the institution compares the previous day’s V*a*R estimate of the institution’s

exposure in respect of each counterparty (in aggregate the counterparty portfolio) to the change in the institution's actual exposure in respect of the counterparty portfolio in the previous day;

(c) where the change is calculated as the difference between the net value of the counterparty portfolio on the previous day calculated using today's market prices and the net value of that counterparty portfolio calculated using the previous day's market prices;

(d) where if the change exceeds the previous day's estimate, an exception occurs; and

(e) where, depending on the number of exceptions in the observations for the 20 counterparties over the most recent 250 days, the output of the model will be scaled up by using a multiplier as specified in *Table 11*.]

Table 11

Multiplier for exceptions

Zone	Number of exceptions	Multiplier
Green Zone	0 – 19	None (=1)
	20 – 39	None (=1)
	40 – 59	None (=1)
	60 – 79	None (=1)
	80 - 99	None (=1)
Yellow Zone	100 – 119	1.13
	120 – 139	1.17
	140 – 159	1.22
	160 – 179	1.25
	180 - 199	1.28
Red Zone	200 or more	1.33

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

53. Application

An authorized institution may take into account the effect of recognised guarantees and recognised credit derivative contracts in calculating the institution's risk-weighted exposure.

54. Recognised guarantees

A guarantee provided to an authorized institution is recognised if –

(a) the guarantee is provided by –

(i) a sovereign;

(ii) a public sector entity;

(iii) a multilateral development bank;

(iv) a bank;

(v) a securities firm; or

(vi) a corporate which has a current ECAI issuer rating which, if mapped to the scale of uniform credit quality grades in Table C set out in Schedule 2, would result in the corporate being assigned a credit quality grade of 2 or lower,

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; and

(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.

55. Recognised credit derivative contracts

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

(a) the counterparty to the credit derivative contract is –

(i) a sovereign;

(ii) a public sector entity;

(iii) a multilateral development bank;

(iv) a bank;

(v) a securities firm; or

(vi) a corporate which has a current ECAI issuer rating which, if mapped to the scale of uniform credit quality grades in Table C set out in *Schedule 2*, would result in the corporate being assigned a credit quality grade of 2 or lower,

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 recognised 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 circumstances ("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 *subrule (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 recognised 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 recognised credit derivative contract to the extent of 60% of the payable amount.

(3) In this rule –

"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 *subrules (2), (6)* and *(7)*, where an authorized institution's exposure to an on-balance sheet asset or off-balance sheet exposure of the institution is covered by a recognised guarantee or recognised 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 *subrules (3)* to *(7)*, 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 recognised guarantee or recognised 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) *Rules 38, 39* and *40* shall, with all necessary modifications, be used by an authorized institution to calculate the risk-weighted amount under *subrule (1)* or *(2)(c)*.

(4) Subject to *subrule (5)*, where under a recognised guarantee or recognised credit derivative contract there is a currency mismatch, then, to the extent that a calculation required by *subrule (3)* 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 by the use of *Formula 11*.

Formula 11

Calculation of haircut for recognised guarantee or recognised credit derivative contract where there is currency mismatch

$G_a = G \times (1-H_{fx})$

where:

G_a = the covered portion adjusted for a currency mismatch;

G = the amount payable to the authorized institution under the credit protection; and

H_{fx} = the haircut applicable in consequence of a currency mismatch between the credit protection and the exposure.

(5) For the purposes of the use of *Formula 11* –

(a) subject to *paragraph (b)*, the haircut represented by H_{fx} shall be taken to be 8%;

(b) that haircut shall be adjusted in accordance with *Formula 6* if the credit protection has a minimum holding period which is shorter or

longer than 10 business days or is not revalued or remargined daily as assumed in the standard supervisory haircuts.

(6) Where -

(a) a relevant banking supervisory authority permits banks within the jurisdiction in which it operates as such authority to allocate a lower risk-weight to claims on its sovereign that are denominated and funded in the lawful currency of that jurisdiction ("domestic currency"); and

(b) the covered portion of an authorized institution's exposure -

(i) is funded in the domestic currency; and

(ii) is the subject of a recognised guarantee by that sovereign denominated in the domestic currency,

then the institution may allocate the lower risk-weight to that covered portion.

(7) Where the covered portion of an authorized institution's exposure -

(a) is such covered portion by virtue of a recognised guarantee ("original guarantee"); and

(b) is the subject of a counter-guarantee issued by a sovereign,

then the institution may, in respect of the covered portion, treat the counter-guarantee as if it were the original guarantee if –

(c) the counter-guarantee –

(i) covers all credit risk elements of the exposure to the extent that it relates to the covered portion; and

(ii) is granted in such terms that it can be called if for any reason the obligor fails to make payments due in respect of the underlying exposure and if the original guarantee could be called;

(d) the original guarantee and the counter-guarantee meet all of the requirements for guarantees set out in *rule 54* (except that the counter-guarantee need not be a guarantee given directly and explicitly with respect to the institution's underlying exposure); and

(e) the institution reasonably considers the cover of the counter-guarantee to be adequate and effective and there is no evidence to suggest that the coverage of the counter-guarantee is less effective than that of a direct and explicit guarantee by a sovereign.

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 recognised 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 predetermined 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) 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 collateralised by cash deposit.

(3) Where the credit protection in respect of an authorized institution's underlying exposure consists of a recognised 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 recognised first-to-default credit derivative contract, the institution shall only recognise 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 exposure amongst the exposures to all the reference entities in the relevant basket in accordance with these Rules 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.

(5) Where the credit protection in respect of an authorized institution's underlying exposure consists of a recognised 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 exposure 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 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.

(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 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 1*.

Division 10 – Multiple recognized credit risk mitigation and maturity mismatches

58. Multiple recognised credit risk mitigation

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

(a) 2 or more forms of recognised credit risk mitigation have been used by the institution; or

(b) there is an overlap of coverage between 2 or more forms of recognised 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 on-balance sheet asset or lowest risk-weighted off-balance sheet exposure, as the case may be.

(2) Where an authorized institution has an exposure to a counterparty in respect of which credit protection has been provided by a single protection provider in circumstances where the relevant credit protection has different maturities, then the

institution shall calculate the risk-weighted amount of the exposure in accordance with these Rules by dividing the exposure into different portions reflecting the maturity of the credit protection respectively attributable to the different portions.

(3) 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 assets 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)*, shall aggregate the risk-weighted assets to determine the total amount of its risk-weighted assets 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 (other than the netting of repo-style transactions, OTC derivative transactions and credit derivative contracts) has a residual maturity which is shorter than the residual maturity of the underlying exposure (“maturity mismatch”), then the institution shall adjust the value of the credit protection by the use of *Formula 12*.

Formula 12

Adjustment of calculation of value of credit protection where there is maturity mismatch

P_a = $P \times (t - 0.25) / (T - 0.25)$

where:

P_a = value of credit protection adjusted for maturity mismatch;

P = value of credit protection adjusted for haircuts for price volatility of collateral and foreign currency mismatch (if applicable);

t = Min (T, residual maturity of recognised credit risk mitigation protection) expressed in years; and

T = Min (5, residual maturity of the underlying exposure) expressed in years.

(2) Where there is a maturity mismatch between credit protection and the underlying exposure of an authorized institution, the institution, in calculating its risk-weighted on-balance sheet assets and risk-weighted off-balance sheet exposures –

(a) shall only take into account the credit protection if the credit protection has an original maturity of not less than one year;

(b) shall not take into account the credit protection once it has a residual maturity of not more than 3 months; and

(c) shall not take into account the credit protection if the underlying exposure is secured by recognised collateral and the risk-weighted amount is calculated by using the simple approach to the treatment of collateral.

(3) 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 recognised 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.

(4) For the purposes of this rule, the residual maturity of credit protection which is recognised collateral falling within *rule 34(1)(a)* shall be taken to be the period for which it will continue to fulfil the requirements of *rule 32* applicable to the credit protection.

PART 5

CALCULATION OF OPERATIONAL RISK

Division 1 - Basic indicator approach to calculation of operational risk

60. Application of *Division 1*

This Division shall apply to an authorized institution which uses the BIA to calculate its operational risk.

61. Calculation of capital charge

(1) Subject to *subrule (2)*, an authorized institution shall at the end of each calendar quarter ("calendar quarter end date"), determine its gross income for the 3 years ("last 3 years") ending on the calendar quarter end date by –

(a) aggregating the gross income recognised by the institution in the calendar quarter ending on the calendar quarter end date and in each of the immediately preceding 3 calendar quarters ("first year");

(b) aggregating the gross income recognised by the institution in the 4 calendar quarters immediately preceding the first year ("second year");

(c) aggregating the gross income recognised by the institution in the 4 calendar quarters immediately preceding the second year ("third year");

(d) multiplying the gross income of the institution in each of the first, second and third years, where positive, by a capital charge factor of 15%; and

(e) aggregating the capital charges calculated under *paragraph (d)* for the last 3 years and dividing that aggregate figure by the number of the last 3 years in which gross income has been positive.

(2) Subject to *subrule (3)*, an authorized institution shall, under *subrule (1)*, for the purposes of calculating the capital charge for its operational risk, use *Formula 13*.

Formula 13

Calculation of capital charge for operational risk

K_{BIA} = $[\Sigma(GI_{1...n} \times \alpha)] / n$

where:

K_{BIA} = the capital charge under the BIA for calculating operational risk;

GI = gross income, where positive, of the last 3 years;

n = number of the last 3 years for which gross income is positive; and

α = 15%

(3) An authorized institution shall, in using the formula set out in *subrule (2)*, exclude from the numerator (GI) and the denominator (n) any of its gross income for a year that is negative or zero.

62. Calculation of risk-weighted amount

An authorized institution shall calculate its risk-weighted amount for operational risk by multiplying the capital charge for its operational risk as calculated under *rule 61* by 12.5.

Division 2 - Standardised approach to calculation of operational risk

63. Application of *Division 2*

This Division shall apply to an authorized institution which uses the STO to calculate its operational risk.

64. Mapping of authorized institution's business activities into standardised business lines

An authorized institution shall, based on the principles specified in *paragraph 2* of *Schedule 1*, map its business activities, and the gross income derived from each of those business activities, into the following 8 standardised business lines as read with the provisions of *Schedule 4* –

(a) corporate finance;

(b) trading and sales;

(c) retail banking;

(d) commercial banking;

(e) payment and settlement;

(f) agency services;

(g) asset management; and

(h) retail brokerage.

65. Calculation of capital charge

(1) Subject to *subrule (3)*, an authorized institution shall, at the end of each calendar quarter ("calendar quarter end date"), determine the capital charge for each standardised business line for the 3 years ("last 3 years") ending on the calendar quarter end date by –

(a) aggregating –

(i) the gross income recognised by the institution in respect of each of the standardised business lines in the calendar quarter ending on the calendar quarter end date; and

(ii) the gross income recognised by the institution in respect of each of the standardised business lines in each of the immediately preceding 3 calendar quarters ("first year");

(b) aggregating the gross income recognised by the institution in respect of each of the standardised business lines in the 4 calendar quarters immediately preceding the first year ("second year");

(c) aggregating the gross income recognised by the institution in respect of each of the standardised business lines in the 4 calendar quarters immediately preceding the second year ("third year"); and

(d) multiplying the gross income of the institution for each standardised business line in each of the first, second and third years calculated in *paragraphs (a), (b)* and *(c)* by the capital charge factor assigned to the business line set out in *Table 12*.

Table 12

Capital charge factor applicable to standardised business lines

Standardised business lines	**Capital charge factors**
Corporate finance	18%
Trading and sales	18%
Retail banking	12%
Commercial banking	15%
Payment and settlement	18%
Agency services	15%
Asset management	12%
Retail brokerage	12%

(2) Subject to *subrule (3)*, an authorized institution shall calculate the capital charge for the institution's operational risk by –

(a) adding together the 8 capital charges calculated under *subrule (1)* in respect of each of the standardised business lines for each of the last 3 years; and

(b) aggregating the capital charges calculated under *paragraph (a)* for the last 3 years and obtaining the mean average of the aggregate capital charges for the last 3 years by dividing that aggregate figure by 3.

(3) Subject to *subrule (4)*, an authorized institution shall, for the purposes of calculating under *subrules (1)* and *(2)* the capital charge for its operational risk, use *Formula 14*.

Formula 14

Calculation of capital charge for operational risk

$K_{STO} = \{\Sigma_{years\ 1\text{-}3} \max [\Sigma(GI_{1\text{-}8} \times \beta_{1\text{-}8}), 0]\} / 3$

where:

K_{STO} = the capital charge under the STO for calculating operational risk;

$GI_{1\text{-}8}$ = gross income for each of the standardised business lines for each of the last 3 years; and

$\beta_{1\text{-}8}$ = the capital charge factor assigned to each of the standardised business lines as specified in *Table 12*.

(4) An authorized institution, in using *Formula 14* -

(a) may, in any given year of the last 3 years, offset a positive capital charge for any standardised business line in the given year with a negative capital charge for any other standardised business line in the given year;

(b) shall not offset positive or negative capital charges for standardised business lines between any of the last 3 years;

(c) if the aggregate capital charge for all the standardised business lines in any given year of the last 3 years is negative, shall assign a zero value to that aggregate capital charge and count the given year in the denominator when calculating the last 3 years mean average.

66. Calculation of risk-weighted amount

An authorized institution shall calculate its risk-weighted amount for operational risk by multiplying the capital charge for its operational risk as calculated under *rule 65* by 12.5.

Division 3 - Alternative standardised approach to calculation of operational risk

67. Application of *Division 3*

This Division shall apply to an authorized institution which uses the ASA to calculate its operational risk.

68. Application of *rule 65* to all standardised business lines of authorized institution except retail banking and commercial banking

An authorized institution shall comply with *rule 65* (including *subrule (3)* of that rule) in respect of all of its standardised business lines except retail banking and commercial banking.

69. Calculation of capital charge for operational risk in retail banking

(1) Subject to *subrule (4)*, an authorized institution shall, at the end of each calendar quarter ("calendar quarter end date"), calculate the amount outstanding in respect of loans and advances in its retail banking business line for the 3 years ("last 3 years") ending on the calendar quarter end date by –

(a) taking the mean average of the amount outstanding in respect of the loans and advances as at the calendar quarter end date and as at the end of each of the immediately preceding 3 calendar quarters ("first year");

(b) taking the mean average of the amount outstanding in respect of the loans and advances as at the end of each of the 4 calendar quarters immediately preceding the first year ("second year"); and

(c) taking the mean average of the amount outstanding in respect of the loans and advances as at the end of each of the 4 calendar quarters immediately preceding the second year ("third year").

(2) An authorized institution shall multiply each of the 3 figures calculated under *subrule (1)(a), (b)* and *(c)* by a factor of 0.035.

(3) Subject to *subrule (4)*, an authorized institution shall calculate the capital charge for operational risk in respect of its retail banking business line for each of the last 3 years by multiplying the figures obtained by the application of *subrule (2)* for the first, second and third years by a capital charge factor of 12%.

(4) An authorized institution shall, for the purposes of calculating under *subrules (1), (2)* and *(3)* the capital charge for operational risk in its retail banking business line, use *Formula 15*.

Formula 15

Calculation of capital charge for operational risk in retail banking

K_{RB} = LA_{RB} x 0.035 x β_{RB}

where:

K_{RB} = the capital charge for the retail banking business line;

LA_{RB} = loans and advances in the retail banking business line for each year; and

β_{RB} = the capital charge factor for the retail banking business line.

70. Calculation of capital charge for operational risk in commercial banking

An authorized institution shall comply with *rule 69* in respect of its commercial banking business line as if -

(a) every reference in that rule (including *Formula 15*) to retail banking business line were a reference to commercial banking business line; and

(b) a capital charge factor of 15% were substituted in *subrule (3)* of that rule for the capital charge factor of 12% specified in that subrule.

71. Calculation of capital charge

(1) Subject to *subrules (2),* (*3)* and *(4)*, an authorized institution shall calculate its capital charge for operational risk by -

(a) adding together the capital charges for its operational risk calculated under *rules 68, 69* and *70* for each of the last 3 years; and

(b) taking the mean average of the aggregate capital charges obtained under *paragraph (a)*.

(2) Subject to *subrule (3)*, an authorized institution may, in any given year of the last 3 years, offset a positive capital charge for any standardised business line, other than retail banking and commercial banking, in the given year with a negative capital charge for any other standardised business line, other than retail banking or commercial banking, in the given year.

(3) Where the aggregate capital charge for all the standardised business lines, other than retail banking and commercial banking, of an authorized institution in any given year of the last 3 years is negative, the institution –

(a) shall assign a zero value to that aggregate capital charge; and

(b) shall not offset the capital charge for the retail banking or commercial banking business line with that negative aggregate capital charge.

(4) An authorized institution may -

(a) aggregate the total gross income for all of its standardised business lines except retail banking and commercial banking if the

institution applies a capital charge factor of 18% to those standardised business lines;

(b) aggregate the loans and advances for its retail banking business line and commercial banking business line if the institution applies a capital charge factor of 15% to those standardised business lines.

72. Calculation of risk-weighted amount

An authorized institution shall calculate its risk-weighted amount for operational risk by multiplying the capital charge for its operational risk as calculated under *rule 71* by 12.5.

Division 4 – Exceptions

73. Provisions applicable where certain authorized institutions have difficulties with BIA, STO or ASA

Where an authorized institution -

(a) has been in operation for less than 18 months on any calendar quarter end date subsequent to the date on which this rule comes into operation;

(b) has recorded negative gross income for the last 3 years immediately preceding that date; or

(c) is undergoing a merger, acquisition or material restructuring,

then the institution –

(d) shall not adopt the BIA, STO or the ASA to calculate its operational risk except with the prior approval of the Monetary Authority;

(e) may, with the prior approval of the Monetary Authority, adopt an alternative to the BIA, STO or ASA to calculate its operational risk.

74. Transitional

Where on any calendar quarter end date subsequent to the date on which this rule comes into operation an authorized institution has been in operation -

(a) for 18 months or more but less than 3 years, the institution shall treat any partial year of operation of 6 months or more as a full year, and any partial year of operation of less than 6 months as zero, for the purposes of calculating, under the BIA, STO or ASA, the last 3 years mean average of its gross income, loans and advances in the retail banking business line or loans and advances in the commercial banking business line, as the case requires;

(b) for 2½ years or more but less than 3 years, the institution shall –

(i) annualize the gross income of the partial year and use a denominator of 3;

(ii) in the case of an institution adopting the ASA, calculate the aggregate of its loans and advances in the retail banking business line and its loans and advances in the commercial banking business line for the partial year by taking the mean average of the amount outstanding at the end of each full calendar quarter within the partial year;

(c) for 18 months or more but less than 2 years, the institution shall–

(i) annualize the gross income of the partial year and use a denominator of 2;

(ii) in the case of an institution adopting the ASA, calculate the aggregate of its loans and advances in the retail banking business line and its loans and advances in the commercial banking business line for the partial year by taking the mean average of the amount outstanding at the end of each full calendar quarter within the partial year;

(d) for more than 2 years but less than 2½ years, the institution shall treat its gross income for the partial year or its loans and advances in the retail banking business line and its loans and advances in the commercial banking business line, for the partial year, as the case requires, as zero and use a denominator of 2.

PART 6

CALCULATION OF MARKET RISK

(This Part is temporarily vacant)

PART 7

ASSET SECURITISATION

(This Part is temporarily vacant)

SCHEDULE 1

[*rule 5*]

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

1. The Monetary Authority is satisfied that -

    (a) the board of directors and senior management of the authorized institution are actively involved in -

        (i) the oversight of the institution's entire risk management framework; and

        (ii) the management of the institution's operational risk;

    (b) the authorized institution has a dedicated operational risk management function to which specific duties have been assigned, including -

        (i) the development of strategies to identify, assess, monitor, control and mitigate the degree of operational risk to which the institution is exposed;

        (ii) the establishment of policies and procedures, in writing, applicable to the matters referred to in *subparagraph (i)*; and

        (iii) the development and implementation of -

            (A) an operational risk assessment methodology appropriate for the institution; and

(B) a reporting system for operational risk that is appropriate for the institution; and

(iv) ensuring that the persons involved in the matters referred to in *subparagraph (i)* have ready access to the policies and procedures referred to in *subparagraph (ii)*;

(c) the authorized institution has all of its policies, and controls and procedures, relating to its system for the management of its operational risk well documented, including policies to deal with any failure to comply with such policies or such controls and procedures;

(d) the authorized institution has implemented a system to ensure compliance with the policies, and controls and procedures, referred to in *paragraph (c)*;

(e) the authorized institution has implemented a system requiring regular reports to be made -

(i) of information concerning the institution's operational risk, including -

(A) the results of any self-risk assessment of the institution's operational risk;

(B) the key risk indicators;

(C) information concerning the actual or potential losses that have arisen or may arise as a result of the institution's operational risk that are, in the context

of the volume of the institution's business, material; and

(D) information concerning major operational events affecting the institution's operational risk;

(ii) to the managers of the various business units of the institution and the chief executives and directors of the institution; and

(iii) of information of such a nature and within such time frame as will support the proactive management of the institution's operational risk;

(f) the authorized institution has established procedures for taking appropriate and timely action in response to the information provided pursuant to reports referred to in *paragraph (e)*;

(g) the authorized institution has an established assessment system for its operational risk which is -

(i) capable of systematically keeping track of relevant data concerning the institution's operational risk, in particular any material losses arising due to operational risk in different business lines of the institution; and

(ii) closely integrated into the institution's processes for the management of its operational risk;

(h) the authorized institution has resources sufficient to –

(i) properly use the STO or ASA to calculate its operational risk in relation to the institution's major business lines;

(ii) properly control such use of the STO or ASA; and

(iii) audit such use, and audit such control of such use, of the STO or ASA;

(i) the authorized institution's process for the management of its operational risk and the system for assessing its operational risk are subject to validation and regular independent reviews by the institution's internal auditors or by external auditors; and

(j) the reviews referred to in *paragraph (i)* include the activities of particular business units of the institution and of the operational risk management function of the institution.

2. The Monetary Authority is satisfied that -

(a) the authorized institution has, for the purposes of using the STO or ASA to calculate its operational risk, policies and criteria in writing applicable to the institution's mapping of the gross income it recognises from its current business lines into the standardised business lines;

(b) the authorized institution has in place a system for regularly reviewing and revising the policies and criteria referred to in *paragraph (a)* to ensure that they continue to be appropriate for new or changing activities or products;

(c) the authorized institution has categorized, or is capable of categorizing, all its business activities into the 8 standardised business lines by the application of the following principles -

(i) each business activity of the institution is to be mapped into only one of the standardised business lines;

(ii) any business activity of the institution which cannot be readily mapped into one of the standardised business lines but which is ancillary to one only of the standardised business lines is allocated to the standardised business line to which it is so ancillary;

(iii) any business activity of the institution which cannot be readily mapped into one of the standardised business lines but which is ancillary to 2 or more standardised business lines ("relevant business lines") is allocated to one only, or to 2 or more, of the relevant business lines by the application of objective mapping criteria (which may be, or include, allocation to that relevant business line to which the business activity is principally ancillary, or to 2 or more relevant business lines in proportion to the time spent on the respective relevant business lines);

(iv) where none of the principles set out in *subparagraphs (i), (ii)* and *(iii)* enables the institution to map gross income in respect of a particular business activity ("relevant business

activity") into a particular standardised business line, the institution -

(A) attributes the gross income to any standardised business line allocated the highest capital charge factor under the calculation framework set out in *rule 65(1)(d)* of these Rules; and

(B) also allocates to that standardised business line any business activity which is ancillary to the relevant business activity;

(v) if the institution uses internal pricing methods to allocate gross income between standardised business lines, the total gross income for the institution must still equal the sum of the gross income for the 8 standardised business lines;

(vi) the institution's mapping of its business activities into standardised business lines for the purposes of calculating its operational risk is consistent with the definitions of standardised business lines used for the calculation of the institution's credit risk or market risk or, if there is an inconsistency -

(A) the inconsistency is readily identified as such in writing; and

(B) the reasons for the inconsistency are set out in writing;

(vii) the institution keeps a record in writing of -

(A) the definitions used by it of its standardised business lines for the purposes of calculating its operational risk;

(B) the processes used by it to map its business activities into the standardised business lines; and

(C) any exceptions (including inconsistencies) to the policies or criteria applied by the institution in mapping its business activities into the standardised business lines;

(viii) the institution has established systems, policies and procedures to readily map into its standardised business lines any new business activity carried out or to be carried out by the institution or any new product provided or to be provided by the institution;

(ix) the senior management of the institution is responsible for the development, implementation and oversight of the institution's policy in relation to mapping its business activities into the standardised business lines and the board of directors of the institution are responsible for approving the principal elements of that policy and any major revision to those elements; and

(x) the process by which the institution maps its business activities into the standardised business lines is regularly reviewed by a party independent from that process.

[SCHEDULE 2

[*rules 10, 14, 15, 16,* and *34*]

UNIFORM CREDIT QUALITY GRADES

TABLE A

CLAIMS ON SOVERIGNS

Credit quality grade (sovereigns)	Standard and Poor's Corporation	Moody's Investors Service, Inc.	Fitch Ratings Ltd.
1	AAA	Aaa	AAA
	AA+	Aa1	AA+
	AA	Aa2	AA
	AA-	Aa3	AA-
2	A+	A1	A+
	A	A2	A
	A-	A3	A-
3	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
	BBB-	Baa3	BBB-
4	BB+	Ba1	BB+
	BB	Ba2	BB
	BB-	Ba3	BB-
5	B+	B1	B+
	B	B2	B
	B-	B3	B-
6	CCC+	Caa1	CCC+
	CCC	Caa2	CCC
	CCC-	Caa3	CCC-
	CC	Ca	CC
	C	C	C
	D		D

TABLE B

CLAIMS ON BANKS AND SECURITIES FIRMS

Credit quality grade (banks and securities firms)	Standard and Poor's Corporation	Moody's Investors Service, Inc.	Fitch Ratings Ltd.
1	AAA	Aaa	AAA
	AA+	Aa1	AA+
	AA	Aa2	AA
	AA-	Aa3	AA-
2	A+	A1	A+
	A	A2	A
	A-	A3	A-
3	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
	BBB-	Baa3	BBB-
4	BB+	Ba1	BB+
	BB	Ba2	BB
	BB-	Ba3	BB-
	B+	B1	B+
	B	B2	B
	B-	B3	B-
5	CCC+	Caa1	CCC+
	CCC	Caa2	CCC
	CCC-	Caa3	CCC-
	CC	Ca	CC
	C	C	C
	D		D

TABLE C

CLAIMS ON CORPORATES

Credit quality grade (corporates)	Standard and Poor's Corporation	Moody's Investors Service, Inc.	Fitch Ratings Ltd.
1	AAA	Aaa	AAA
	AA+	Aa1	AA+
	AA	Aa2	AA
	AA-	Aa3	AA-
2	A+	A1	A+
	A	A2	A
	A-	A3	A-
3	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
	BBB-	Baa3	BBB-
4	BB+	Ba1	BB+
	BB	Ba2	BB
	BB-	Ba3	BB-
5	B+	B1	B+
	B	B2	B
	B-	B3	B-
	CCC+	Caa1	CCC+
	CCC	Caa2	CCC
	CCC-	Caa3	CCC-
	CC	Ca	CC
	C	C	C
	D		D

TABLE D

SHORT-TERM CLAIMS (CORPORATES, BANKS AND SECURITIES FIRMS)

Short-term credit quality grade (corporates, banks and securities firms)	Standard and Poor's Corporation	Moody's Investors Service, Inc.	Fitch Ratings Ltd.
1	A-1	P-1	F-1
2	A-2	P-2	F-2
3	A-3	P-3	F-3
4	Others	Others	Others]

SCHEDULE 3

[*rule 2(1)*]

STANDARD SUPERVISORY HAIRCUTS FOR

COMPREHENSIVE APPROACH TO TREATMENT OF COLLATERAL

1. Authorized institutions using the comprehensive approach to treatment of collateral for collateralised transactions are required to use the haircuts provided in the table below to take account of the price volatility of both the underlying exposure and the collateral. These haircuts assume daily marking-to-market, daily remargining and a 10-business day minimum holding period.

(Figures below are in percentages)

Table

<table>
<tr><th colspan="2">Exposure/Recognised Collateral for Credit Risk Mitigation</th><th rowspan="2">Sovereigns[1]</th><th rowspan="2">Other issuers[2]</th></tr>
<tr><th>Credit Quality Grade / Short-term Credit Quality Grade</th><th>Residual Maturity</th></tr>
<tr><td rowspan="3">• Grade 1</td><td>≤1 year</td><td>0.5</td><td>1</td></tr>
<tr><td>> 1 year, ≤5 years</td><td>2</td><td>4</td></tr>
<tr><td>> 5years</td><td>4</td><td>8</td></tr>
<tr><td rowspan="3">• Grades 2 & 3
• Unrated securities issued by banks (or entities treated as banks) satisfying the criteria for recognised collateral</td><td>≤1 year</td><td>1</td><td>2</td></tr>
<tr><td>> 1 year, ≤5 years</td><td>3</td><td>6</td></tr>
<tr><td>> 5years</td><td>6</td><td>12</td></tr>
<tr><td>• Grade 4 for sovereigns</td><td>All</td><td>15</td><td></td></tr>
<tr><td colspan="2">• Equities in main index (including convertible bonds) and gold</td><td colspan="2">15</td></tr>
<tr><td colspan="2">• Other equities (including convertible bonds) listed on a recognised exchange</td><td colspan="2">25</td></tr>
</table>

[1] Haircuts for sovereigns should be applied to multilateral development banks and to sovereign foreign public sector entities.

[2] Other issuers include public sector entities that are not sovereign foreign public sector entities. For the purpose of applying haircuts to such public sector entities, authorized institutions should refer to the credit quality grade assigned to the sovereigns in which the public sector entities are incorporated or established. Where the credit quality grade assigned to the sovereign is grade 4 or below, the securities issued by the public sector entities will not be recognised for banking book transactions (but will still be recognised in the case of repo-style transactions in the trading book, with the application of a 25% haircut – see *paragraph 2* of this Schedule).

Table - continued

Exposure/Recognised Collateral for Credit Risk Mitigation		**Sovereigns**[1]	**Other issuers**[2]
Credit Quality Grade / Short-term Credit Quality Grade	**Residual Maturity**		
• Collective investment schemes		Highest haircut applicable to any financial instruments in which the scheme can invest	
• Cash in the same currency		0	

2. For transactions in which an authorized institution lends to a counterparty instruments that are not included in this table (for example, non-investment grade corporate debt securities) the haircut to be applied to the exposure should be the same as the haircut for equity traded on a recognised exchange that is not part of a main index (that is, 25%).

3. In cases where the underlying exposure and collateral are denominated in different currencies, a standard supervisory haircut for currency risk of 8% should be imposed to further reduce the value of the collateral. This haircut is also based on daily marking-to-market and a 10-business day minimum holding period.

4. In the case of repo-style transactions, haircuts reflecting price volatility of the underlying exposure and collateral involved in the transactions could be lowered to 0% if the criteria specified in *rule 37(2)* are satisfied.

5. For repo-style transactions that are treated as collateralized loans in the authorized institution's trading book, the category of recognised collateral may be expanded to include all assets received by the authorized institution (as mentioned in *rule 35(d)* of these Rules*)*. Assets falling outside the definition of recognised collateral (as set out in this table) should be subject to a 25% haircut.

SCHEDULE 4

[*rules 2(1)* and *64*]

DETAILED DEFINITION OF EACH STANDARDISED BUSINESS LINE

Business lines under the Standardised Approach and the Alternative Standardised Approach to the calculation of operational risk	Major business segments	Activity groups
Corporate Finance	Corporate Finance	mergers and acquisitions, underwriting, privatizations, securitisation, research, debt (sovereign, high yield), equity, syndications, IPO, secondary private placements
	Municipal/Government Finance	
	Merchant Banking	
	Advisory Services	
Trading and Sales	Sales	fixed income, equity, foreign exchange, commodities, credit, funding, own position securities, lending and repos, brokerage, debt, prime brokerage
	Market Making	
	Proprietary Positions	
	Treasury	
Retail Banking	Retail Banking	retail lending and deposits, banking services, trust and estates
	Private Banking	private lending and deposits, banking services, trust and estates, investment advice
	Card Services	merchant/commercial/corporate cards, private labels and retail
Commercial Banking	Commercial Banking	project finance, real estate, export finance, trade finance, factoring, leasing, lending, guarantees, bills of exchange
Payment and Settlement[1]	External Clients	payments and collections, fund transfer, clearing and settlement
Agency Services	Custody	escrow, depository receipts, securities lending (customers), corporate actions
	Corporate Agency	issuer and paying agents
	Corporate Trust	
Asset Management	Discretionary Fund Management	pooled, segregated, retail, institutional, closed, open, private equity
	Non-Discretionary Fund Management	pooled, segregated, retail, institutional, closed, open
Retail Brokerage	Retail Brokerage	execution only and full service

[1] Payment and settlement losses related to an authorized institution's own activities would be allocated to the standardised business lines to which the transaction occasioning the payment and settlement loss is most closely related.

Dated this day of 2006

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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. *Rule 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. *Rule 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 standardised approach to the calculation of an authorized institution's operational risk).

Part 2 - Application of these Rules

4. *Rule 3* specifies that an authorized institution must use the basic indicator approach to calculate its operational risk (see *Division 1* of *Part 5*) unless it has the approval of the Monetary Authority ("MA") to use the standardised approach to calculate its operational risk (see *Division 2* of *Part 5*) or the alternative standardised approach to calculate its operational risk (see *Division 3* of *Part 5*). *Rule 4* empowers the MA, in the circumstance specified in *rule 4(1)(b)*, to require an authorized institution which is using the standardised or alternative standardised approach to calculate its operational risk to use the basic indicator approach to calculate its operational risk in respect of all of its business or such parts of its business as the MA specifies. *Rule 5* provides for applications to the MA by authorized institutions seeking the MA's approval to use the standardised or alternative standardised approach to calculate their operational risk and the MA's determination of the applications. It should be noted that the MA is prohibited from granting any such approval if the authorized institution concerned is unable to satisfy the MA that the relevant criteria specified in *Schedule 1* to the Rules are fulfilled with respect to the institution.

Part 3 - Determination of Capital Base

5. This Part is temporarily vacant.

Part 4 - Calculation of Credit Risk

Division 1 - Application

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

Division 2 - Calculation of credit risk under STC and assets and exposures to be covered in calculation

7. *Rule 7* specifies how an authorized institution shall calculate its credit risk under the standardised approach and *rule 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. *Rule 7* also specifies that an authorized institution may take into account the effect of any recognised credit risk mitigation for the purposes of calculating its risk-weighted assets and risk-weighted exposures. (See the definition of "recognised credit risk mitigation" in *rule 2(1)* as read with the definitions of "credit

protection", "nettable", "recognised collateral", "recognised credit derivative contract", "recognised guarantee", "recognised netting" and "valid bilateral netting agreement" in that rule). *Rule 9* requires an authorized institution to classify each of its on-balance sheet assets into one only of the categories specified in that rule (for example, claims on sovereigns, claims on banks 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 *rule 7(1)*. The assets and exposures falling within *rule 8* are risk-weighted (by reference to the categories set out in *rule 9*) as specified in *rules 10* to *21*. In the case of *rules 10*, *12*, *14*, *15* and *16*, the risk-weighting is done by reference to credit assessment ratings assigned by external credit assessment institutions to various persons or to debt obligations issued or undertaken by various persons. (In this respect, see the definitions of "credit quality grade", "current", "ECAI", "ECAI issue specific rating", "ECAI issuer rating", "ECAI rating", "external credit assessment institution", "long-term ECAI issue specific rating" and "short-term ECAI issue specific rating" in *rule 2(1)* as read with *Schedule 2* to the Rules). *Rule 22(2)* to *(5A)* specifies what an authorized institution must do if there is more than one applicable current ECAI rating falling within a subrule of any rule of *Part 4*. *Rule 22A* requires an authorized institution to use only the credit assessment rating of ECAIs nominated by it for the purposes of *Part 4*.

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

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

Division 6 - Use of collateral in credit risk mitigation

10. *Rule 32* specifies the collateral which is recognised for the purposes of calculating the risk-weighted amounts of an authorized institution's on-balance sheet assets or off-balance sheet exposures. *Rule 33* specifies the circumstances in which an authorized institution may or must use the simple or the comprehensive approach in respect of the treatment of recognized collateral (see the definitions of “comprehensive approach” and

"simple approach" in *rule 2(1)*). *Rule 34* specifies the recognised collateral which may be used under the simple approach while *rule 35* specifies the recognised collateral that may be used under the comprehensive approach.

Division 6A – Provisions applicable to credit risk mitigation under simple approach to treatment of collateral

10A. *Rule 36* specifies how an authorized institution shall calculate its risk-weighted assets and risk-weighted exposures taking into account the effect of recognised credit risk mitigation under the simple approach to the treatment of collateral. *Rule 37* specifies how an authorized institution shall determine the risk-weight to be allocated to recognised collateral under the simple approach. *Rule 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, *rules 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 - Provisions applicable to credit risk mitigation under comprehensive approach to treatment of collateral

11. *Division 7* specifies how an authorized institution shall calculate the risk-weighted amounts of its on-balance sheet assets and off-balance sheet exposures under the comprehensive approach to the treatment of recognised collateral. The provisions of the Division need to be read in conjunction with the definitions of "haircut" and "standard supervisory haircut" in *rule 2(1)* and *Schedule 3* to the Rules.

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 (*rule 54*) and credit derivative contracts (*rule 55*) that are recognised 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. *Rule 56* specifies that if an authorized institution's exposure to an on-balance sheet asset or off-balance sheet exposure is covered by a recognised guarantee or recognised 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 instead of the risk-weight of the counterparty. *Rule 57* contains special provisions in respect of credit protection consisting of recognised credit derivative contracts which are credit default swaps or total return swaps. (See the definitions of "credit default swap" and "total return swap" in *rule 2(1)*).

Division 10 **- Multiple recognised credit risk mitigation and maturity mismatches**

14. *Rule 58* specifies what an authorized institution must do where an exposure of the institution has 2 or more distinct or overlapping forms of recognised credit risk mitigation in respect of a single exposure of the institution to a counterparty. *Rule 59* specifies what an authorized institution must do when there is a maturity mismatch between the credit protection provided in respect of an underlying exposure of the institution and the underlying exposure (see the definition of "maturity mismatch" in *rule 2(1)*).

Part 5 - Calculation of Operational Risk

Division 1 - Basic indicator approach to calculation of operational risk

15. *Division 1* specifies that an authorized institution shall calculate its risk-weighted amount for operational risk under the basic indicator approach by multiplying the capital charge for operational risk calculated under *rule 61* by the factor of 12.5 specified in *rule 62*.

Division 2 - Standardised approach to calculation of operational risk

16. *Division 2* specifies that an authorized institution shall calculate its risk-weighted amount for operational risk under the standardised approach by mapping its business activities (and the gross income derived from those business activities) into the 8 standardised business lines specified in *rule 64* as read with *Schedule 4* to the Rules, calculating an aggregate capital charge for its operational risk in respect of those standardised business lines in accordance with *rule 65*, and then multiplying that aggregate capital charge by a factor of 12.5 as specified in *rule 66*.

Division 3 - Alterative standardised approach to calculation of operational risk

17. The alternative standardised approach to the calculation of operational risk set out in *Division 3* is essentially the same as the standardised approach except the commercial banking business line and the retail banking business line where loans and advances (instead of gross income) will be used to calculate the operational risk capital charge (see *rules 69* and *70*).

Division 4 - Exceptions

18. *Division 4* specifies that authorized institutions may, in certain circumstances and with the prior approval of the MA, adopt alternatives to the approaches to operational risk specified in *Part 5* (*rule 73*). The Division also specifies transitional provisions for the purposes of *Part 5*.

Part 6 - Calculation of Market Risk

19. This Part is temporarily vacant.

Part 7 - Asset Securitisation

20. This Part is temporarily vacant.

Annex E

First draft (Second batch)

(re: Part 2 – Application of These Rules

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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

In these Rules, unless the context otherwise requires -

"available-for-sale" ( ), in relation to a financial asset or financial instrument, has the meaning assigned to it by Hong Kong Accounting Standard 39;

"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*;

"book value" ( ), in relation to any thing, means the thing's current book value after deducting the amount of any allowance for impairment loss arising from an individual assessment of the thing for impairment loss in accordance with Hong Kong Accounting Standard 39;

"cash flow hedge" ( ) means the hedging relationship defined in paragraph 86 of Hong Kong Accounting Standard 39;

"collective provisions" ( ), in relation to the on-balance sheet assets of an authorized institution, means an allowance for impairment loss arising from a collective assessment of the assets for impairment loss in accordance with Hong Kong Accounting Standard 39;

"connected company" ( ), in relation to an authorized institution, means -

(a) a subsidiary, or the holding company, of the institution; or

(b) a company which falls within section 64(1)(b), (c), (d) or (e) of the Ordinance in respect of the institution;

"consolidated basis" ( ), in relation to the calculation of an authorized institution's capital adequacy ratio, means the institution calculates that ratio on the basis set out in *section 13*;

"consolidation group" ( ), in relation to an authorized institution, means -

(a) the institution; and

(b) if the institution is the subject of -

(i) a section 98(2) requirement falling within *paragraph (a)* or *(c)* of the definition of "section 98(2) requirement", all the subsidiaries of the institution;

(ii) a section 98(2) requirement falling within *paragraph (b)* or *(d)* of the definition of "section 98(2) requirement", such subsidiaries of the institution as are specified in the requirement;

"consolidation requirement" ( ), in relation to a subsidiary of an authorized institution, means -

(a) a section 79A(1) requirement whereby a provision of Part XV of the Ordinance is to apply to the institution on a consolidated basis in respect of that subsidiary; or

(b) a section 98(2) requirement whereby the capital adequacy ratio of the institution is to be calculated on a consolidated basis in respect of that subsidiary;

"core capital" ( ), in relation to an authorized institution, means the sum, calculated in Hong Kong dollars, of the book values of the institution's capital items specified in *section 17*;

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

"dilution risk" ( ), in relation to a receivable purchased by an authorized institution, means the possibility that the amount of the receivable is reduced through cash or non-cash credits to the receivable's obligor;

"EAD" ( ) means exposure at default;

"EL" ( ) means expected loss;

"EL amount" ( ), in relation to an exposure of an authorized institution, means the expected loss amount of the exposure calculated by multiplying the EL of the exposure by the EAD of the exposure;

"eligible provisions" ( ), in relation to an authorized institution which uses the IRB to calculate its credit risk, means the sum of -

(a) the institution's regulatory reserves for general banking risks, specific provisions, partial write-offs and collective provisions that are attributed to exposures which are subject to the IRB; and

(b) any discounts on exposures referred to in *paragraph (a)* which are in default;

"eligible subsidiary" ( ), in relation to the calculation of an authorized institution's capital adequacy ratio, means a subsidiary which falls within *section 10(2)*;

"EP" ( ) means eligible provisions;

"equivalent subordinated debt" ( ) means a capital instrument specified in a notice under *subsection (2)(a)* to be equivalent, for the purposes of these Rules, to subordinated debt referred to in *paragraph (a)* of the definition of "other regulatory capital instrument";

"expected loss" ( ), in relation to an exposure of an authorized institution which uses the IRB to calculate its credit risk, means the expected loss on the exposure arising from the potential default of the obligor or dilution in respect of the exposure over a one year period relative to the EAD of the exposure;

"exposure at default" ( ), in relation to an exposure of an authorized institution which uses the IRB to calculate its credit risk, means the expected amount of the exposure -

(a) upon the default of the obligor in respect of the exposure; and

(b) measured gross of specific provisions and partial write-offs;

"fair value" ( ) -

(a) in relation to an asset, means the amount for which the asset could be exchanged between knowledgeable, willing parties in an arm's length transaction;

(b) in relation to a liability, means the amount for which the liability could be settled between knowledgeable, willing parties in an arm's length transaction;

"forecast transaction" ( ) has the meaning assigned to it by paragraph 9 of Hong Kong Accounting Standard 39;

"incorporated" ( ) includes established;

"guarantee" ( ) includes an indemnity;

"insurance firm" ( ) -

(a) means an entity -

(i) authorized and supervised by a relevant insurance 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 an authorized insurer within the meaning of the Insurance Companies Ordinance (Cap. 41);

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

"irredeemable" ( ), in relation to non-cumulative preference shares, means that the shares are -

(a) irredeemable; or

(b) irredeemable except with the prior consent of the Monetary Authority;

"loans designated as available-for-sale" ( ), in relation to an authorized institution, means the loans that the institution upon initial recognition designates as available-for-sale in accordance with Hong Kong Accounting Standard 39;

"other regulatory capital instrument" ( ) means -

(a) subordinated debt -

(i) issued by an authorized institution incorporated in Hong Kong; and

(ii) included in the institution's supplementary capital; or

(b) a capital instrument -

(i) issued by a company which is not an authorized institution incorporated in Hong Kong but which is -

(A) subject to supervision by a financial regulator; and

(B) subject to capital requirements imposed on it in the country in which the financial regulator is such financial regulator; and

(ii) which is similar to subordinated debt falling within *paragraph (a)*;

"PD/LGD approach" ( ), in relation to an equity exposure of an authorized institution, means the use of the IRB to calculate the institution's credit risk in respect of equity exposures as specified in *section [..]*;

"restricted insurance regulator" ( ) means an insurance regulator specified in *Part [..]* of *Schedule 1A*;

"securities not held for trading purposes" ( ), in relation to an authorized institution, means securities -

(a) held by the institution other than those which are acquired principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

(b) designated by the institution as securities not held for trading purposes;

"section 98(2) requirement" ( ), in relation to an authorized institution, means a requirement in a notice under section 98(2) of the Ordinance whereby the capital adequacy ratio of the institution is to be calculated on -

(a) a consolidated basis in respect of all the subsidiaries of the institution;

(b) a consolidated basis in respect of such subsidiaries of the institution as are specified in the notice;

(c) the consolidated basis referred to in *paragraph (a)* and an unconsolidated basis; or

(d) the consolidated basis referred to in *paragraph (b)* and an unconsolidated basis unless otherwise specified in the notice;

"section 79A(1) requirement" ( ), in relation to an authorized institution, means a requirement in a notice under section 79A(1) of the Ordinance whereby a provision of Part XV of the Ordinance is to apply to the institution on -

(a) a consolidated basis in respect of all the subsidiaries of the institution;

(b) a consolidated basis in respect of such subsidiaries of the institution as are specified in the notice;

(c) the consolidated basis referred to in *paragraph (a)* and an unconsolidated basis; or

(d) the consolidated basis referred to in *paragraph (b)* and an unconsolidated basis unless otherwise specified in the notice;

"solo basis" ( ), in relation to the calculation of an authorized institution's capital adequacy ratio, means the institution calculates that ratio on the basis set out in *section 11*;

"solo-consolidated basis" ( ), in relation to the calculation of an authorized institution's capital adequacy ratio, means the institution calculates that ratio on the basis set out in *section 12*;

"solo-consolidated subsidiary" ( ), in relation to an authorized institution, means a subsidiary of the institution specified in an approval under *section 12(2)(a)* granted to the institution;

"special purpose vehicle" ( ), in relation to an authorized institution, means a company or other entity -

(a) established by the institution for the sole purpose of raising capital for the institution; and

(b) which does not trade or conduct any business except raising capital for the institution;

"specified amount" ( ), in relation to an authorized institution, means any amount that the institution is required under *section 23(2)* to deduct from its core and supplementary capital;

"SPV" ( ) means a special purpose vehicle;

"subsidiary undertaking" ( ) has the meaning assigned to it by the Twenty-third Schedule to the Companies Ordinance (Cap. 32);

"supplementary capital" ( ), in relation to an authorized institution, means the sum, calculated in Hong Kong dollars, of the book value of the institution's capital items specified in *section 18*;

"total EL amount" ( ), in relation to an authorized institution which uses the IRB to calculate its credit risk, means the sum of the institution's EL amount attributed to sovereign, bank, corporate and retail exposures of the institution which are subject to the IRB;

"total EP" ( ), in relation to an authorized institution which uses the IRB to calculate its credit risk, means the sum of the institution's eligible provisions attributed to sovereign, bank, corporate and retail exposures of the institution which are subject to the IRB;

"transitional period" ( ) means the period commencing on and including 1 January 2007 and ending on and including 31 December 2009.

PART 2

APPLICATION OF THESE RULES

Division 2 - Prescribed calculation approaches

3. Calculation of credit risk

An authorized institution shall -

(a) subject to *paragraphs (b)* and *(c)*,only use the STC to calculate its credit risk;

(b) subject to *paragraph (c)*, only use the BSA to calculate its credit risk if it has the approval to do so under *section 4(2)(a)*;

(c) only use the IRB to calculate its credit risk if it has the approval to do so under *section 4(2)(a)*

4. Application by authorized institution for approval to use BSA or IRB to calculate its credit risk

(1) An authorized institution may make an application to the Monetary Authority for approval to calculate its credit risk by using the BSA or IRB.

(2) Subject to *subsection (3)*, the Monetary Authority shall determine an application under *subsection (1)* from an authorized institution by -

(a) granting approval to the institution to calculate its credit risk by using the BSA or IRB; or

(b) refusing to grant such approval.

(3) Without limiting the generality of *subsection (2)(b)*, the Monetary Authority shall refuse to grant approval to an authorized institution to use the BSA or IRB to calculate its credit risk if -

(a) in the case of the BSA, any one or more of the criteria specified in *section 5* applicable to or in relation to the institution are not fulfilled with respect to the institution;

(b) in the case of the IRB, any one or more of the criteria specified in *section 6* applicable to or in relation to the institution are not fulfilled with respect to the institution.

[(4) Provision not used.]

5. Minimum criteria for approval under *section 4(2)(a)* to use BSA to calculate credit risk of authorized institution

An authorized institution making an application under *section 4(1)* to use the BSA to calculate its credit risk must satisfy the Monetary Authority -

(a) that -

(i) the institution and its consolidation group, if any, each had, at the end of the financial year immediately preceding the date of the application, total assets, before any specific and collective provisions, of not more than $10 billion; and

(ii) there is no cause to believe that the use by the institution of the BSA to calculate its credit risk would not adequately identify, assess and reflect the credit risk of the institution's exposures taking into account the nature of the institution's business; or

(b) that -

(i) the institution has an implementation plan for the use of the IRB to calculate its credit risk which, in form and substance, is adequate for that purpose; and

(ii) the institution is reasonably likely to fulfil, not later than the end of the transitional period, the criteria specified in *section 6* applicable to and in relation to an institution seeking to use the IRB to calculate its credit risk.

[6. Minimum criteria for approval under *section 4(2)(a)* to use IRB to calculate credit risk of authorized institution

An authorized institution making an application under *section 4(1)* to use the IRB to calculate its credit risk must satisfy the Monetary Authority that -

(a) ………………………………………………………………;

(b) ………………………………………………………………; and

(c) ………………………………………………………………. .]

7. Authorized institution shall not use BSA to calculate its credit risk after expiration of transitional period except on ground specified in *section 5(a)*

Subject to *section 9*, where approval under *section 4(2)(a)* has been granted to an authorized institution to use the BSA to calculate its credit risk on the ground specified in *section 5(b)*, then -

(a) the institution may, during the transitional period, use the BSA to calculate its credit risk in respect of such exposures of the institution for which the institution does not have approval under *section 4(2)(a)* to calculate its credit risk using the IRB; and

(b) the institution shall, immediately after the expiration of the transitional period, use the STC to calculate its credit risk in respect of such exposures of the institution for which the institution does not have approval under *section 4(2)(a)* to use the IRB to calculate its credit risk.

8. Provisions applicable where authorized institution may use combination of STC, BSA or IRB to calculate credit risk

(1) Where under these Rules an authorized institution may use more than one relevant approach to calculate its credit risk in respect of an exposure of the institution falling within a class of exposures of the institution, then the institution shall not -

(a) use more than one such approach to calculate its credit risk in respect of all of its exposures falling within that class; or

(b) discontinue using one such approach, and commence using another such approach, to calculate its credit risk in respect of all of its exposures falling within that class,

except with the prior consent of the Monetary Authority.

[(2) Where under these Rules an authorized institution which uses the IRB to calculate its credit risk may use more than one IRB recognized approach to calculate its credit risk in respect of an exposure of the institution falling within a class of exposures of the institution, then the institution shall not -

(a) use more than one such IRB recognized approach to calculate its credit risk in respect of all of its exposures falling within that class; or

(b) discontinue using one such IRB recognized approach, and commence using another such IRB recognized approach, to calculate its credit risk in respect of all of its exposures falling within that class,

except with the prior consent of the Monetary Authority.]

(3) In this section –

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

["IRB recognized approach" ( ) means -

(a) in respect of corporate exposures, the foundation IRB, the advance IRB or the supervisory slotting criteria approach;

(b) in respect of sovereign exposures, the foundation IRB or the advanced IRB;

(c) in respect of bank exposures, the foundation IRB or the advanced IRB;

(d) in respect of retail exposures, the IRB; and

(e) in respect of equity exposures, the simple risk-weight method or the internal models method under the market-based approach or the PD/LGD approach.]

9. Action that may be taken by Monetary Authority if authorized institution using BSA or IRB to calculate its credit risk no longer meets criteria specified in *section 5* [or *6*]

(1) Where -

(a) an authorized institution uses the BSA or IRB to calculate its credit risk; and

(b) the Monetary Authority is satisfied that, if the institution were to make a fresh application under *section 4(1)* for approval to use the BSA or the IRB, as the case may be, to calculate its credit risk, such approval would be refused by virtue of *section 4(3)*,

then the Monetary Authority may, by notice in writing given to the institution -

(c) in the case of an institution using the BSA to calculate its credit risk, require the institution to use the STC to calculate its credit risk instead of the BSA -

(i) in respect of all of its business, or parts of its business, as specified in the notice; and

(ii) beginning on such date, or the occurrence of such event, as is specified in the notice;

[(d) in the case of an institution using the IRB to calculate its credit risk -

(i) request the institution to -

(A) submit to the Monetary Authority a plan which satisfies the Monetary Authority that, if it were

implemented by the institution, would mean that the institution would rapidly cease to fall within *paragraph (b)*; and

(B) implement such plan;

(ii) require the institution, if it fails or refuses to comply with the request referred to in *subparagraph (i)*, to use the STC to calculate its credit risk instead of the IRB -

(A) in respect of all of its business, or parts of its business, as specified in the notice; and

(B) beginning on such date, or the occurrence of such event, as is specified in the notice;

(iii) take one or more than one of the following measures until the institution ceases to fall within *paragraph (b)* -

(A) require the institution to calculate its credit risk by using the STC instead of the IRB -

(I) in respect of such parts of its business as are specified in the notice; and

(II) beginning on such date, or the occurrence of such event, as is specified in the notice;

(B) advise the institution that the Monetary Authority is considering exercising the Monetary Authority's power under *section 101* of the Ordinance to vary

the capital adequacy ratio of the institution by increasing it;

(C) require the institution to be subject to a capital floor as specified in *section [..]*; or

(D) require the institution to adopt such measures specified in the notice which, in the opinion of the Monetary Authority, will cause the institution to cease to fall within *paragraph (b)* or will otherwise mitigate the effect of the institution falling within that paragraph.

(2) An authorized institution shall comply with a requirement referred to in *subsection (1)(c)* or *(d)(ii)* or *(iii)(A)*, *(C)* or *(D)* of a notice given to it under *subsection (1)*.]

Division 4 - Solo, solo-consolidated and consolidated bases for calculation of capital adequacy ratio

10. Calculation of capital adequacy ratio on solo basis, solo-consolidated basis or consolidated basis

(1) An authorized institution shall -

(a) use the solo basis to calculate its capital adequacy ratio or, if it has the approval to do so under *section 12(2)(a)*, use the solo-consolidated basis to calculate its capital adequacy ratio; and

(b) subject to *section 15*, use the consolidated basis to calculate its capital adequacy ratio covering risk-weighted amounts for all relevant risks of the consolidation group, if any.

(2) Subject to *section 15*, the Monetary Authority may in a section 98(2) requirement, require the capital adequacy ratio of an authorized institution to be calculated on a consolidated basis in respect of a subsidiary of the institution (other than a subsidiary which is an insurance firm or securities firm) where -

(a) more than 50% of the total assets/total income of the subsidiary consist of the carrying out of one or more than one relevant financial activity; or

(b) the Monetary Authority is satisfied that, after taking into account the nature of the business undertaken by the subsidiary, the institution must calculate its capital adequacy ratio on a consolidated basis in respect of that subsidiary if a relevant risk of the institution is to be adequately identified and assessed.

(3) In this section -

"relevant financial activity" ( ), in relation to a subsidiary of an authorized institution, means -

(a) an activity which is ancillary to a principal activity of the institution, including -

(i) owning and managing the institution's property; and

(ii) performing information technology functions for the institution;

(b) lending, including -

(i) the provision of consumer or mortgage credit;

(ii) factoring;

(iii) forfaiting; and

(iv) the provision of guarantees and other financial commitments;

(c) financial leasing;

(d) money transmission services;

(e) issuing and administering a means of payment, including -

  (i) credit cards;

  (ii) travellers' cheques; and

  (iii) bank drafts;

(f) trading for the company's own account, or for accounts of the company's customers, in -

  (i) money market instruments;

  (ii) foreign exchange;

  (iii) financial instruments which are traded on an exchange;

  (iv) OTC derivative transactions; or

  (v) transferable securities;

(g) participating in securities issues, including the provision of services relating to the issues;

(h) the provision of -

(i) advice to undertakings on capital structure or industrial strategy, including any matter related to capital structure or industrial strategy; or

(ii) advice and services relating to mergers and the purchase of undertakings;

(i) money broking; or

(j) portfolio management and the provision of advice in relation to portfolio management.

11. Solo basis for calculation of capital adequacy ratio

(1) An authorized institution shall in calculating its capital adequacy ratio on a solo basis -

(a) aggregate the institution's (including the institution's local branches and overseas branches) risk-weighted amounts for -

(i) credit risk as calculated in accordance with *Division [..]*, *[..]* or *[..]* of *Part 4*;

(ii) operational risk as calculated in accordance with *Division 1*, *2* or *3* of *Part 5*; and

(iii) market risk as calculated in accordance with *Division [..]* or *[..]* of *Part 6*; and

(b) determine the institution's capital base, in accordance with *Part 3*, to reflect the fact that it is calculating its capital adequacy ratio on a solo basis.

(2) For the avoidance of doubt, it is hereby declared that, for the purposes of this section, an authorized institution shall risk-weight the exposures of an overseas branch of the institution in accordance with the provisions of these Rules.

12. Solo-consolidated basis for calculation of capital adequacy ratio

(1) An authorized institution may make an application to the Monetary Authority for approval to calculate its capital adequacy ratio on a solo-consolidated basis instead of a solo basis in respect of such of its subsidiaries that are members of its consolidation group as are specified in the application.

(2) Subject to *subsection (3)*, the Monetary Authority shall determine an application under *subsection (1)* from an authorized institution by -

(a) granting approval to the institution to calculate its capital adequacy ratio on a solo-consolidated basis instead of a solo basis in respect of such subsidiaries of the institution as are specified in the approval and giving the institution a section 98(2) requirement to give effect to such approval; or

(b) refusing to grant such approval.

(3) Without limiting the generality of *subsection (2)(b)*, the Monetary Authority shall refuse to grant approval to an authorized institution to calculate its capital adequacy ratio on a solo-consolidated basis instead of a solo basis in respect of a subsidiary of the institution unless the institution satisfies the Monetary Authority that -

(a) the subsidiary is wholly owned by, and managed as if it were an integral part of, the institution;

(b) the subsidiary is wholly financed by the institution such that the subsidiary has no depositors or other external creditors except external creditors for -

(i) audit fees;

(ii) company secretarial services; and

(iii) sundry operating expenses; and

(c) there are no regulatory, legal or taxation constraints on the transfer of the subsidiary's capital to the institution.

(4) Subject to *subsection (5)*, an authorized institution shall in calculating its capital adequacy ratio on a solo-consolidated basis -

(a) aggregate the institution's (including the institution's local branches and overseas branches), and its solo-consolidated subsidiaries', risk-weighted amounts for -

(i) credit risk as calculated in accordance with *Division [..]*, *[..]* or *[..]* of *Part 4*;

(ii) operational risk as calculated in accordance with *Division 1*, *2*, or *3* of *Part 5*; and

(iii) market risk as calculated in accordance with *Division [..]* or *[..]* of *Part 6*; and

(b) determine the institution's capital base, in accordance with *Part 3*, to reflect the fact that it is calculating its capital adequacy ratio on a solo-consolidated basis.

(5) An authorized institution which calculates its capital adequacy ratio on a solo-consolidated basis shall ensure that, in calculating that ratio, the risk-weighting of a relevant risk does not include inter-company balances with, and transactions between, the institution and its solo-consolidated subsidiaries.

(6) An authorized institution which has been granted an approval under *subsection (2)(a)* shall give notice in writing to the Monetary Authority -

(a) of the occurrence of any event ("relevant event") which could reasonably be construed as causing, or potentially causing, whether by itself or in conjunction with any other event, a subsidiary of the institution to fall outside paragraph *(a)*, *(b)* or *(c)* of *subsection (3)*; and

(b) as soon as is practicable after the occurrence of the relevant event.

13. Consolidated basis for calculation of capital adequacy ratio

(1) An authorized institution shall in calculating its capital adequacy ratio on a consolidated basis -

(a) aggregate the consolidation group's (including the institution's local branches and overseas branches) risk-weighted amounts for -

(i) credit risk as calculated in accordance with *Division [..]*, *[..]* or *[..]* of *Part 4*;

(ii) operational risk as calculated in accordance with *Division 1*, *2* or *3* of *Part 5*; and

(iii) market risk as calculated in accordance with *Division [..]* or *[..]* of *Part 6*; and]

(b) determine the consolidation group's capital base, in accordance with *Part 3*, to reflect the fact that it is calculating its capital adequacy ratio on a consolidated basis.

(2) Subject to *section 13A*, it is hereby declared that, under the consolidated basis for the calculation of the capital adequacy ratio of an authorized institution, the institution shall ensure that -

(a) the risk-weighting of a relevant risk does not relate to the exposures of a subsidiary of the institution which is not a member of the consolidation group; and

(b) risk-weighting of a relevant risk does not include inter-company balances with, and transactions between, members of the consolidation group.

(3) An authorized institution which calculates its capital adequacy ratio on a consolidated basis shall give notice in writing to the Monetary Authority of -

(a) the following matters -

(i) a subsidiary ceasing to be a subsidiary of the institution;

(ii) a new subsidiary of the institution;

(iii) the principal activities of a subsidiary referred to in *subparagraph (ii)*;

(iv) any significant change to the principal activities of the institution or any of its subsidiaries (including a subsidiary referred to in *subparagraph (ii)*); and

(b) as soon as is practicable after the institution is aware of the matter or ought reasonably to be aware of the matter.

13A. Provisions supplementary to *section 13*

[(1) Provision not used.]

(2) With the prior consent of the Monetary Authority, an authorized institution which calculates its capital adequacy ratio on a consolidated basis may use the IRB, in combination with the STC or BSA, or both, to calculate its credit risk on that basis if -

(a) the IRB will be so used for not less than -

(i) subject to *subparagraph (ii)*, 85% of the total credit risk-weighted exposures of the consolidation group calculated in accordance with [*Part 4*];

(ii) 75% of the total credit risk-weighted exposures of the consolidation group calculated in accordance with [*Part 4*] during the transitional period if *paragraph (a)* of *section 7* is applicable to the institution; and

(b) it satisfies the Monetary Authority that it is not practicable for the IRB to be solely used to calculate the institution's credit risk on that basis.

(3) With the prior consent of the Monetary Authority, an authorized institution which calculates its capital adequacy ratio on a consolidated basis may use the IMA in combination with the STM to calculate its market risk on that basis if it satisfies

the Monetary Authority that it is not practicable for the IMA to be solely used to calculate the institution's market risk on that basis.

(4) An authorized institution which calculates its capital adequacy ratio on a consolidated basis may, insofar as its market risk is concerned -

(a) net off balances between members of the consolidation group; and

(b) offset market risk positions between members of the consolidation group,

if -

(c) the market risk positions of the members are monitored and managed on a group basis;

(d) there are no regulatory, legal or taxation constraints to mutual financial support between the members; and

(e) there are no regulatory, legal or taxation constraints or the transfer of funds between the members.

(5) Where an authorized institution which calculates its capital adequacy ratio on a consolidated basis uses the BIA to calculate its operational risk, then -

(a) subject to *paragraph (b)*, the institution may, in calculating the gross income of the consolidation group in any given year of the last 3 years, offset a positive gross income of a member of the

group in the given year with a negative gross income of another member of the group in that given year;

(b) the institution shall not, pursuant to *paragraph (a)*, offset positive gross income with negative gross income between any of the last 3 years.

(6) Where an authorized institution which calculates its capital adequacy ratio on a consolidated basis uses the STO or ASA to calculate its operational risks then -

(a) subject to *paragraph (b)*, the institution may, in calculating the gross income of the consolidation group in any given year of the last 3 years, offset a positive gross income of a standardized business line of a member of the group in the given year with a negative gross income of that standardized business line of another member of the group in that given year;

(b) the institution shall not, pursuant to *paragraph (a)*, offset positive gross income with negative gross income between any of the last 3 years.

(7) Subject to *subsection (8)*, an authorized institution which calculates its capital adequacy ratio on a consolidated basis shall do so using the same approach in calculating a relevant risk as it would be required to use if it were calculating that ratio on an unconsolidated basis.

(8) An authorized institution is not required to comply with *subsection (7)* in respect of such members of the consolidation group as the Monetary Authority permits in a prior consent given by the Monetary Authority to the institution.

[**14. Provision not used]**

15. Exceptions to *section 10*

(1) Where -

(a) an authorized institution calculates its capital adequacy ratio on a consolidated basis; and

(b) an eligible subsidiary of the institution incorporated in a country other than Hong Kong calculates its capital adequacy ratio on a solo basis in accordance with the capital adequacy standards applicable in that country,

then the institution may make an application to the Monetary Authority for approval to risk-weight the eligible subsidiary's exposures in accordance with those standards instead of in accordance with these Rules.

(2) Subject to *subsection (3)*, the Monetary Authority shall determine an application under *subsection (1)* from an authorized institution by -

(a) granting approval to the institution to risk-weight the exposures of the eligible subsidiary specified in the application in accordance with the capital adequacy standards applicable in the country where the eligible subsidiary is incorporated instead of in accordance with these Rules and giving the institution a section 98(2) requirement to give effect to such approval; or

(b) refusing to grant such approval.

(3) Without limiting the generality of *subsection (2)(b)*, the Monetary Authority shall refuse to grant approval to an authorized institution to risk-weight the exposures of an eligible subsidiary of the institution in accordance with the capital adequacy standards applicable in the country in which the eligible subsidiary is incorporated instead of in accordance with these Rules unless the institution satisfies the Monetary Authority that the use of those standards would not cause a significant impact on the institution's capital adequacy ratio.

(4) An authorized institution which calculates its capital adequacy ratio on a consolidated basis may make an application to the Monetary Authority for approval to calculate that ratio by excluding one or more than one member from the consolidation group.

(5) Subject to *subsection (6)*, the Monetary Authority shall determine an application under *subsection (4)* from an authorized institution by -

(a) granting approval to the institution to calculate its capital adequacy ratio by excluding from the consolidation group such members of the group as the Monetary Authority specifies and giving the institution a section 98(2) requirement to give effect to such approval; or

(b) refusing to grant such approval.

(6) Without limiting the generality of *subsection(5)(b)*, the Monetary Authority shall refuse to grant approval to an authorized institution to calculate its capital

adequacy ratio by excluding from the consolidation group any member of the group unless the institution satisfies the Monetary Authority that the inclusion of that member in the group -

(a) would be inappropriate or misleading; or

(b) is not practicable due to regulatory, legal or taxation constraints on the transfer of information necessary to enable the institution to calculate that ratio on a consolidated basis in respect of that member.

PART 3

DETERMINATION OF CAPITAL BASE

16. Determination of capital base

(1) Subject to *subsection (2)* and to *sections 22* and *23*, an authorized institution shall determine its capital base by adding together the institution's total core capital and total supplementary capital.

(2) The total supplementary capital of an authorized institution, before making any deductions therefrom required by *section 23(2)*, which may be included in the determination of the institution's capital base shall not exceed the institution's total core capital -

(a) after making the deductions therefrom required by *section 23(1)*; but

(b) before making the deductions therefrom required by *section 23(2)*.

17. Core capital of authorized institution

(1) Subject to *sections 18A(5)*, *18B(2)*, *19(3)(a)*, *22* and *23*, the core capital of an authorized institution shall consist of -

(a) the institution's paid-up ordinary share capital except any shares issued by the institution by virtue of capitalising any property revaluation reserves of the institution referred to in *section 18(1)(a)*;

(b) the institution's paid-up irredeemable non-cumulative preference shares;

(c) the amount standing to the credit of the institution's share premium account;

(d) subject to *section 17B*, the institution's published reserves except -

(i) unrealized fair value gains and losses on revaluation of loans designated as available-for-sale;

(ii) cumulative fair value gains or losses on the hedged items and the hedging instrument in respect of cash flow hedges created for -

(A) available-for-sale financial instruments; and

(B) financial instruments measured at amortised cost;

(iii) cumulative fair value gains or losses on the hedging instrument that are recognized directly in equity through the statement of changes in equity in respect of cash flow hedges created for forecast transactions; and

(iv) any published reserves falling within *paragraph (e)* or *section 18*;

(e) subject to *section 17C*, the institution's unaudited profit or loss of the current financial year, and the institution's profit or loss of the immediately preceding financial year pending audit completion, except -

(i) any unrealised fair value gains or losses on financial liabilities arising from any change in the institution's credit worthiness; and

(ii) any profit or loss referred to in *section 18*; and

(f) subject to *section 17D*, minority interests in the equity of the institution's subsidiaries arising from a consolidation requirement except any such minority interests that are not freely transferable to -

(i) the institution; or

(ii) members of the group of companies of which the institution is a member,

after taking into account any relevant regulatory, legal or taxation constraints on the transfer of capital.

(2) In *subsection (1)(e)(i)*, "fair value gains or losses" ( ), in relation to an authorized institution, means the institution's fair value gains or losses gross of any deferred tax provisions attributable to the fair value gains or losses.

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

17B. Provisions supplementary to *section 17(d)*

An authorized institution's published reserves falling within *section 17(d)* as at a particular date shall be net of dividends -

(a) proposed or declared by the institution after that date; and

(b) that, as at that date, are recorded, or are required to be recorded, as equity on the institution's balance sheet.

17C. Provisions supplementary to *section 17(e)*

(1) An authorized institution's profit or loss falling within *section 17(e)* as at a particular date shall be net of dividends -

(a) proposed or declared by the institution after that date; and

(b) that, as at that date, are recorded, or are required to be recorded, as equity on the institution's balance sheet.

(2) An authorized institution may, with the prior consent of the Monetary Authority, include in its profit or loss falling within *section 17(e)* any unrealised fair value gains arising from the institution's holding of equities and debt securities designated at fair value through profit or loss in its profit or loss account.

17D. Provisions supplementary to *section 17(f)*

(1) An authorized institution's core capital consisting of minority interests falling within *section 17(f)* that arise on consolidation in the paid-up irredeemable non-cumulative preference shares of the institution's subsidiaries which are SPVs shall not constitute more than 15% of the institution's total core capital (including minority interests falling within that section) after making the deductions therefrom required by *section 23(1)* but before making the deductions therefrom required by *section 23(2)*.

(2) An authorized institution's core capital consisting of minority interests falling within *section 17(f)* as at a particular date shall be net of dividends -

(a) proposed or declared by the institution's subsidiaries after that date; and

(b) that, as at that date, are recorded, or are required to be recorded, as equity on the subsidiaries' balance sheets.

18. Supplementary capital of authorized institution

(1) Subject to *sections 22* and *23*, the supplementary capital of an authorized institution shall consist of -

(a) subject to *section 18A*, that part ("1st relevant part") of the institution's reserves that is attributable to fair value gains in profit or loss on -

(i) the revaluation of the institution's holdings of land and buildings except land and buildings mortgaged to the institution to secure a debt; and

(ii) the revaluation of the institution's share of the net asset value of any subsidiary of the institution to the extent that the value has changed as a result of the revaluation of the subsidiary's holdings of land and buildings except land and buildings mortgaged to the subsidiary to secure a debt;

(b) subject to *section 18B*, that part ("2nd relevant part") of the institution's reserves that is attributable to fair value gains -

(i) on the revaluation of the institution's holdings of equities and debt securities not held for trading purposes; and

(ii) arising from the institution's holdings of equities and debt securities designated at fair value through profit or loss which do not fall within *section 17(e)*;

(ba) with the prior consent of the Monetary Authority, that part of the institution's reserves that is attributable to fair value gains on the

institution's holdings of any other financial assets not held for trading purposes, including such assets that are available-for-sale or designated at fair value through profit or loss;

(c) subject to *section 19*, the institution's regulatory reserves for general banking risks and collective provisions;

(d) the institution's perpetual subordinated debt where, under the terms on which the debt instrument is to be issued, the Monetary Authority is satisfied that the following conditions are met (and, after issue, is satisfied that the following conditions continue to be met) -

(i) the claims of the lender against the institution are fully subordinated to those of all unsubordinated creditors;

(ii) the debt is not secured against any assets of the institution;

(iii) the money advanced to the institution is permanently available to it;

(iv) the debt is not repayable without the prior consent of the Monetary Authority;

(v) the money advanced to the institution is available to meet losses without the institution being obliged to cease trading;

(vi) the institution is entitled to defer the payment of interest where its profitability will not support such payment; and

(vii) if the rate of interest payable on the debt is liable to be increased under the terms of the debt instrument, the rate of interest will not be increased -

(A) until the expiry of 10 years from the day when the debt is issued;

(B) more than once; and

(C) beyond a limit considered appropriate by the Monetary Authority;

(e) the institution's paid-up irredeemable cumulative preference shares where, under the terms on which the shares are to be issued, the Monetary Authority is satisfied that the following conditions are met (and, after issue, is satisfied that the following conditions continue to be met) -

(i) the shares are not redeemable without the prior consent of the Monetary Authority;

(ii) the money raised by the issue of the shares is available to meet losses without the institution being obliged to cease trading; and

(iii) if the dividends payable on the shares are liable to be increased under the terms, such dividends will not be increased -

(A) until the expiry of 10 years from the day when the shares are issued;

(B) more than once; and

(C) beyond a limit considered appropriate by the Monetary Authority;

(f) subject to *section 20*, the institution's term subordinated debt where, under the terms on which the debt instrument is to be issued, the Monetary Authority is satisfied that the following conditions are met (and, after issue, is satisfied that the following conditions continue to be met) -

(i) the claims of the lender against the institution are fully subordinated to those of all unsubordinated creditors;

(ii) the debt is not secured against any assets of the institution;

(iii) the debt has a minimum initial period to maturity of more than 5 years (even though that period may be subsequently reduced with the prior consent of the Monetary Authority);

(iv) any debt repayable prior to maturity will not be so repaid without the prior consent of the Monetary Authority; and

(v) if the rate of interest payable on the debt is liable to be increased under the terms of the debt instrument, the rate of interest will not be increased -

(A) until the expiry of 5 years from the day when the debt is issued;

(B) more than once; and

(C) beyond a limit considered appropriate by the Monetary Authority.

(g) subject to *section 20*, the institution's paid-up term preference shares where, under the terms on which the shares are to be issued, the Monetary Authority is satisfied that the following conditions are met (and, after issue, is satisfied that the following conditions continue to be met) -

(i) the shares have a minimum initial period to maturity of more than 5 years (even though that period may be subsequently reduced with the prior consent of the Monetary Authority);

(ii) any shares redeemable prior to maturity will not be so redeemed without the prior consent of the Monetary Authority; and

(iii) if the dividends payable on the shares are liable to be increased under the terms, such dividends will not be increased -

(A) until the expiry of 5 years from the day when the shares are issued;

(B) more than once; and

(C) beyond a limit considered appropriate by the Monetary Authority; and

(h) subject to *section 21*, minority interests -

(i) in the paid-up irredeemable cumulative preference shares and paid-up term preference shares of the institution's subsidiaries arising from a consolidation requirement imposed on the institution; and

(ii) that are not included in the institution's core capital pursuant to *section 17(f)*.

(2) In *subsection (1)(a)* and *(b)* -

"reserves" ( ), in relation to an authorized institution -

(a) means the institution's reserves gross of any deferred tax provisions attributable to the reserves;

(b) includes, in relation to *subsection (1)(a)*, shares issued by the institution through capitalizing reserves falling within the 1st relevant part of the institution's reserves.

18A. Provisions supplementary to *section 18(1)(a)*

(1) The 1st relevant part of an authorized institution's reserves shall not fall within *section 18(1)(a)* -

(a) unless -

(i) the institution has an established policy on the frequency and method of revaluation of its holdings of land and buildings which is satisfactory to the Monetary Authority;

(ii) the institution does not depart from that policy except after consultation with the Monetary Authority;

(iii) subject to *subparagraph (iv)*, any revaluation of the institution's holdings of land and buildings is undertaken by an independent professional valuer;

(iv) in any case where the institution satisfies the Monetary Authority that, despite all reasonable efforts, it has been unable to obtain the services of an independent professional valuer to undertake the revaluation of all or part, as the case may be, of the institution’s holdings of land and buildings, any revaluation of such holdings undertaken by a person who is not an independent professional valuer is endorsed in writing by an independent professional valuer;

(v) any revaluation of the institution's holdings of land and buildings is -

(A) approved by the institution's external auditors; and

(B) explicitly reported in the institution's audited accounts; and

(b) unless the fair value gains referred to in *section 18(1)(a)* are recognized in accordance with relevant accounting standards and any such gains not recognized on the balance sheet of the institution are excluded from the 1st relevant part.

(2) Subject to *subsections (3)* and (*3A)*, an authorized institution shall not include in its supplementary capital more than 45% of any fair value gains of any item referred to in *section 18(1)(a)* arising from any revaluation referred to in that section.

(3) Subject to *subsection (3A)*, an authorized institution shall only include in its supplementary capital -

(a) that amount of fair value gains referred to in *section 18(1)(a)* which arise from revaluations referred to in *section 18(1)(a)(i)* as does not exceed the amount that was included in the institution's supplementary capital as at -

(i) 31 December 1998 in respect of the like gains as at that date if the institution was an authorized institution on that date; or

(ii) in any other case, the relevant date in respect of the like gains as at that date; and

(b) that amount of fair value gains referred to in *section 18(1)(a)* which arise from revaluations referred to in *section 18(1)(a)(ii)* as

does not exceed the amount that was included in the institution's supplementary capital as at -

(i) 31 December 1998 in respect of the like gains as at that date if the institution was an authorized institution on that date;

(ii) in any other case, the relevant date in respect of the like gains as at that date.

(3A) An authorized institution shall not include any fair value gains referred to in *section 18(1)(a)* for the purposes of determining its capital base unless -

(a) the gains comprise any amount of fair value gains that as at -

(i) 31 December 1998 were reported to the Monetary Authority if the institution was an authorized institution on that date; or

(ii) in any other case, the relevant date were reported to the Monetary Authority; or

(b) the gains arise from a merger or acquisition and the institution has the prior consent of the Monetary Authority to so use the gains.

(4) An authorized institution shall not, in calculating its supplementary capital, set-off losses in respect of land and buildings which are for the institution's own use where the losses are recognized in the institution's profit or loss against unrealised gains that are reflected directly in equity through the statement of changes in equity.

(5) An authorized institution shall deduct from its core capital any cumulative losses of the institution arising from the institution's holdings of land and buildings below

the depreciated cost value (whether or not any such land and buildings are held for the institution's own use or for investment purposes).

(6) In *subsections (3)* and (*3A)* -

"relevant date" ( ), in relation to an authorized institution, means that date after 31 December 1998 on which the institution became an authorized institution;

"supplementary capital" ( ), has the meaning assigned to it by the Third Schedule to the Ordinance as in force on 31 December 1998.

18B. Provisions supplementary to *section 18(1)(b)*

(1) An authorized institution shall not include in its supplementary capital more than 45% of any fair value gains -

(a) referred to in *section 18(1)(b)(i)* arising from any revaluation referred to in that section; and

(b) referred to in *section 18(1)(b)(ii)*.

(2) An authorized institution -

(a) shall deduct from its core capital -

(i) cumulative unrealised losses of the institution -

(A) arising from securities held by the institution for purposes other than trading purposes; and

(b) which fall below the cost of those securities; and

(ii) impairment losses in respect of securities held by the institution for purposes other than trading purposes; and

(b) shall not, for the purposes of *paragraph (a)(ii)*, set-off any impairment losses in respect of securities referred to in that paragraph against any unrealised gains in respect of those securities.

(3) An authorized institution shall deduct from its supplementary capital an overall deficit arising from the revaluation of its holdings of equities and debt securities falling within *section 18(1)(b)* (but excluding any losses falling within *subsection (2)(a)*).

(4) An authorized institution shall exclude from its supplementary capital any unrealised gains and losses on loans designated as available-for-sale.

19. Provisions supplementary to *section 18(1)(c)*

(1) Subject to *subsections (2)* and *(3)*, an authorized institution which uses the BSA or STC, or both, to calculate its credit risk shall not include in its supplementary capital that amount of its reserves for general banking risks and collective provisions which exceeds 1.25% of the institution's total risk-weighted assets and risk-weighted exposures (being the sum of all the institution's risk-weighted assets and risk-weighted exposures for all the institution's exposures to credit risk subject to the BSA or STC, or both, operational risk and market risk).

(2) An authorized institution which uses any combination of the BSA, STC or IRB to calculate its credit risk -

(a) subject to *paragraph (b)*, shall apportion its total regulatory reserves for general banking risks and collective provisions between the BSA, STC or IRB on a pro rata basis according to the proportions of the institution's risk-weighted assets and risk-weighted exposures to credit risk which are calculated using the BSA, STC or IRB, as the case requires;

(b) may, with the prior consent of the Monetary Authority, use its own method for apportioning its total regulatory reserves for general banking risks and collective provisions for recognition as supplementary capital under the BSA or STC, or both, and that is subject to the IRB for the calculation of the institution's credit risk;

(c) shall, after it has carried out the apportionment referred to in *paragraph (a)* or *(b)* -

(i) comply with *subsection (1)* in respect of that portion of its total regulatory reserves for general banking risks and collective provisions which is subject to the BSA or STC, or both, for the calculation of the institution's credit risk; and

(ii) exclude from its supplementary capital that portion of its total regulatory reserves for general banking risks and collective provisions which is subject to the IRB for the calculation of the institution's credit risk.

(3) Where an authorized institution uses the IRB to calculate its credit risk -

(a) subject to *subsection (2)(c)(ii)*, *paragraph (b)* and *section 23(2)(ab)*, the institution shall adjust its core capital or supplementary capital by reference to the difference between the institution's total EP and total EL amount in respect of sovereign, bank, corporate and retail exposures of the institution that are subject to the IRB;

(b) if the total EL amount referred to in *paragraph (a)* is less than the total EP referred to in that paragraph, the institution may include the excess of all the total EP over the total EL amount in its supplementary capital up to a maximum of 0.6% of its total risk-weighted assets and risk-weighted exposures subject to the IRB [but not subject to *Part 7*].

20. Provision supplementary to *section 18(1)(f)* and *(g)*

An authorized institution shall -

(a) in the case of a debt instrument falling within *section 18(1)(f)* or a share falling within *section 18(1)(g)*, for the purposes of calculating its supplementary capital, discount by 20% the original amount of the debt instrument or share, as the case may be, each year during the 4 years immediately preceding the maturity of the debt instrument or share, as the case may be; and

(b) exclude from its supplementary capital any amount by which the sum of the amounts falling within *section 18(1)(f)* and *(g)* exceeds 50% of the total of the institution's core capital -

    (i) after making the deductions therefrom required by *section 23(1)*; but

    (ii) before making the deductions therefrom required by *section 23(2)*.

21. Provisions supplementary to *section 18(1)(h)*

An authorized institution's minority interests falling within *section 18(1)(h)* as at a particular date shall be net of dividends -

(a) proposed or declared by the institution's subsidiaries after that date; and

(b) that, as at that date, are recorded, or are required to be recorded, as equity on the subsidiaries' balance sheets.

22. Essential characteristics of core and supplementary capital

(1) An authorized institution shall not include any capital in its core capital unless the capital -

(a) is subordinated;

(b) is perpetual; and

(c) is non-cumulative.

(2) An authorized institution shall not include any capital in its core or supplementary capital unless the capital -

(a) is freely available to absorb the institution's losses;

(b) ranks behind the claims of depositors and other creditors of the institution in a winding-up of the institution;

(c) in the case of capital taking the form of shares or debt instruments -

(i) the shares permit, without restrictions, the non-payment of a dividend; and

(ii) the debt instruments are subject to a contractual right to defer interest payments; and

(d) is unsecured and fully paid-up.

(3) For the avoidance of doubt, it is hereby declared that guarantees and other types of contingent liability shall not be included in an authorized institution's core or supplementary capital.

(4) An authorized institution shall not issue any capital instrument other than ordinary shares (including issue by way of a subsidiary or SPV of the institution) unless it

has consulted with the Monetary Authority to ascertain whether, under these Rules, the instrument proposed to be issued -

(a) can be included in the institution's core capital;

(b) can be included in the institution's supplementary capital; or

(c) cannot be included in the institution's core or supplementary capital.

(5) An authorized institution shall not include, in its core or supplementary capital, a capital instrument issued at a discount, or only partly in a paid-up form, except to the extent that the proceeds paid-up on the instrument have been received by, and are immediately available to, the issuer of the instrument.

23. Deductions from core and supplementary capital

(1) An authorized institution shall deduct from its core capital -

(a) the amount of goodwill reported as at the reporting calendar quarter end date of the institution, including -

(i) any goodwill relating to the institution's holdings in shares and other regulatory capital instruments which are subject to any deduction required by *subsection (2)*; and

(ii) any goodwill relating to the subsidiaries of the institution;

(b) other intangible assets of the institution reported as at the reporting calendar quarter end date of the institution;

(c) the amount of net deferred tax assets of the institution reported as at the reporting calendar quarter end date of the institution; and

(d) the amount of any gain-on-sale arising from a securitization transaction in respect of securitization exposures that are subject to deduction under the [securitization framework].

(2) Subject to *section 23A(1)*, an authorized institution shall deduct from its core and supplementary capital -

(a) subject to *subsection (1)(a)(i)*, the amount of the institution’s holding of shares in a holding company of the institution;

(ab) if the institution uses the IRB to calculate its credit risk and the institution's total EL amount referred to in *section 19(3)(a)* exceeds the institution's total EP referred to in that section, the excess of the total EL amount over the total EP;

(b) subject to *subsection (1)(a)(i)*, the amount of the institution’s holdings of shares and other regulatory capital instruments issued by a company in which the institution is entitled to exercise, or control the exercise of, more than 20% of the voting power at any general meeting of the company (and whether or not the company is a subsidiary of the institution) but excluding -

  (i) any such shares and other regulatory capital instruments held by the institution in a subsidiary of the institution the subject of a consolidation requirement; or

  (ii) the institution's reserves -

    (A) arising from the revaluation of the holdings of land and buildings of a subsidiary of the institution; and

    (B) not falling within the definition of “reserves” in *section 18(2)*;

(ba) subject to *subsection (1)(a)(i)*, the amount of the institution's holdings in shares and other regulatory capital instruments in any relevant subsidiary undertaking of the institution excluding any such holdings -

  (i) falling within *paragraph (b)*; or

  (ii) excluded from *paragraph (b)* by virtue of falling within *subparagraph (i)* or *(ii)* of *paragraph (b)*;

(c) subject to *subsection (1)(a)(i)*, the amount of the institution’s holding of shares and other regulatory capital instruments issued

by any bank not falling within *paragraph (a)*, *(b)* or *(ba)* except where the institution satisfies the Monetary Authority that the holding -

(i) is not the subject of an arrangement whereby 2 or more persons agree to hold each other's capital; or

(ii) is not otherwise a strategic investment;

(d) subject to *subsection (1)(a)(i)*, the amount of the institution's -

(i) loans to;

(ii) holding of shares and debentures issued by; and

(iii) guarantees of the liabilities of,

a connected company of the institution, not falling within *paragraph (a)*, *(b)*, *(ba)* or *(c)*, unless the institution satisfies the Monetary Authority that the loan was made, the shares and debentures are being held, or the guarantee was given, as the case may be, in the ordinary course of the institution's business;

(e) subject to *subsection (1)(a)(i)*, in the case of the institution's holding of shares in any company not falling within *paragraph (a)*, *(b)*, *(ba)*, *(c)* or *(d)*, where the book value of the holding exceeds 15% of the capital base of the institution as reported in the institution's last quarter end's capital adequacy ratio return, that amount of the book value of the holding which exceeds that 15%;

(f) subject to *subsection (2A)* and *section 23A(3)*, the amount of any relevant capital shortfall in respect of a subsidiary of the institution -

(i) which is a securities firm or insurance firm; and

(ii) which is not the subject of a consolidation requirement imposed on the institution;

(g) if the institution uses the PD/LGD approach to calculate its credit risk in respect of equity exposures, the EL amount of such exposures subject to the corresponding conditions set out in *Part 4* relating to the use of the IRB to calculate credit risk; and

[(h) the amount[, specified as the relevant amount,] of the items listed in *Schedule 5*.]

(2A) Where a subsidiary of an authorized institution which is a securities firm or insurance firm fails to meet the regulatory capital requirements applicable to it, then -

(a) the institution shall, as soon as is practicable after it becomes aware of the failure, give notice in writing to the Monetary Authority of particulars of the securities firm or insurance firm, as the case may be, and the details of the failure; and

(b) the Monetary Authority may, by notice in writing given to the institution, and beginning on such date, or the occurrence of such event, as is specified in the notice, and ending on such date, or the occurrence of such event, as is specified in the notice, require the institution to deduct from the calculation of its capital base an

amount which, in the opinion of the Monetary Authority, represents the shortfall of the securities firm or insurance firm, as the case may be, in meeting those capital adequacy requirements.

(3A) For the avoidance of doubt, it is hereby declared that -

(a) *subparagraph (i)* of *paragraph (b)* of *subsection (2)* does not apply only when an authorized institution is calculating its capital adequacy ratio on a solo basis;

(b) in the case of an authorized institution calculating its capital adequacy ratio on a solo-consolidated basis, the reference to "subsidiary" in *subparagraph (i)* of *paragraph (b)* of *subsection (2)* means a solo-consolidated subsidiary of the institution.

(4) In this section -

"relevant capital shortfall" ( ), in relation to a subsidiary of an authorized institution, means the amount specified in a notice under *subsection (2A)* given to the institution in respect of that subsidiary;

"relevant subsidiary undertaking" ( ), in relation to an authorized institution, means a subsidiary undertaking of the institution which is not a member of the consolidation group but does fall within the range of consolidation specified in accounting standards issued by the Hong Kong Institute of Certified Public Accountants pursuant to section 18A of the Professional Accountants Ordinance (Cap. 50).

23A. Provisions supplementary to *section 23(2)*

(1) An authorized institution shall -

(a) subject to *paragraph (c)* and *subsection (3)*, deduct from its core capital 50% of any specified amount;

(b) subject to *paragraph (c)* and *subsection (3)*, deduct from its supplementary capital 50% of any specified amount; and

(c) deduct from its core capital such amount of any specified amount which cannot be deducted under *paragraph (b)* because it exceeds the amount of supplementary capital available for such deduction under that paragraph.

[(2) Provision not used.]

(3) It is hereby declared that the amount to be deducted under *section 23(2)(f)* by an authorized institution from its core and supplementary capital -

(a) is in addition to any other deduction the institution is required to make under *section 23(2)* from its core and supplementary capital in respect of the subsidiary concerned of the institution; and

(b) represents the amount by which that subsidiary is deficient in meeting its minimum capital requirements.

[24. Provision not used.]

SCHEDULE 5

[*s. 23(2)(h)*]

OTHER DEDUCTIBLE ITEMS UNDER RISK-WEIGHTING FRAMEWORK FOR CREDIT RISK AND ASSET SECURITISATION FRAMEWORK

[This Schedule is temporarily vacant]

Explanatory Note

Part 2 - Application of these Rules

Division 2 - Prescribed calculation approaches

1. *Section 3* specifies that an authorized institution must use the standardized approach ("STC") to calculate its credit risk (see *Part 4*) unless it has the approval of the MA to use the basic approach ("BSA") to calculate its credit risk (see *Part 4*) or the internal ratings-based approach ("IRB") to calculate its credit risk (see *Part 4*). *Section 4* specifies that the MA shall refuse to grant approval to an authorized institution to use the BSA or IRB to calculate its credit risk if any of the criteria specified in *section 5* (in the case of the BSA) or *section 6* (in the case of the IRB) are not fulfilled with respect to the institution.
2. *Section 7* provides that the use by an authorized institution of the BSA to calculate its credit risk on the ground specified in *section 5(b)* is for a transitional period only (see the definition of "transitional period" in *section 2(1)*), as it is intended that such an institution shall eventually use only the STC or IRB, or a combination of the two, to calculate credit risk. *Section 8* provides, inter alia, that an authorized institution shall not use more than one approach (that is, the STC, BSA or IRB) to calculate its credit risk in respect of all its exposures falling within one class of exposures of the institution.

3. *Section 9* specifies the action that may be taken by the MA if an authorized institution which uses the BSA or IRB to calculate its credit risk can no longer fulfil the criteria specified in *section 5* or *6*, as the case may be. Two of the more important actions that may be taken by the MA are to require such an authorized institution to use the STC instead of the BSA or IRB to calculate its credit risk in respect of all or parts of the business as specified by the MA and, in the case of such an authorized institution using the IRB to calculate its credit risk, to require the institution to adopt measures which, in the opinion of the MA, will cause the institution to again fulfil the criteria specified in *section 6* or will cause the effect of not fulfilling such criteria to be mitigated.

Division 4 **- Solo, solo-consolidated and consolidated bases for calculation of capital adequacy ratio**

3A. *Section 10* requires an authorized institution to use both the solo basis and the consolidated basis to calculate its and its consolidation group's capital adequacy ratio. However, an authorized institution may use the solo-consolidated basis instead of the solo basis to calculate its capital adequacy ratio if it has approval to do so under *section 12(2)(a)*. It should be noted that the solo basis for the calculation of an authorized institution's capital adequacy excludes any subsidiaries of the institution from the calculation. The consolidated basis for the calculation includes the authorized institution's subsidiaries specified by the Monetary Authority in a section 98(2) requirement. The solo-consolidated basis

for the calculation of an authorized institution's capital adequacy ratio permits, in effect, certain specialized subsidiaries within the institution's consolidation group to be included in calculating the institution's solo risk-weighted exposures. The definitions of "consolidated basis", "consolidation group", "consolidation requirement", "section 98(2) requirement", "section 79A(1) requirement", "solo basis", "solo-consolidated basis", "solo-consolidated subsidiary" and "subsidiary undertaking" are all relevant to understanding the provisions of *Division 4*.

3B. *Section 11* states what an authorized institution shall do in calculating its capital adequacy ratio on a solo basis. *Section 12* specifies that an authorized institution may make an application to the Monetary Authority for approval to calculate its capital adequacy ratio on a solo-consolidated basis instead of a solo basis, specifies the grounds on which the Monetary Authority grants or refuses such approval and states what the institution shall do, if it is granted such approval, in calculating its capital adequacy ratio on a solo-consolidated basis.

3C. *Section 13* states what an authorized institution shall do in calculating its capital adequacy ratio on a consolidated basis. *Section 13A* contains provisions supplementary to *section 13*.

3D. *Section 15* permits, subject to the approval of the Monetary Authority, certain exceptions to the requirement in *section 10(1)* that an authorized institution calculate its capital adequacy ratio on a consolidated basis. The exceptions relate to approving the institution risk-weighting the exposures of an eligible subsidiary of the institution in accordance with the capital adequacy standards applicable to

the country in which the subsidiary is incorporated, or to excluding certain subsidiaries from the institution's consolidation group.

Part 3 - Determination of Capital Base

4. *Part 3* specifies how an authorized institution determines its capital base. In this respect, the definition of "capital base" in section 2(1) of the Ordinance, as read with the reference to "capital base" in the definition of "capital adequacy ratio" in that section, should be noted.

5. *Section 16(1)* specifies that an authorized institution's capital base is determined by adding together its total core capital and total supplementary capital subject to the restrictions specified in *section 16(1)* and *(2)*. However, an authorized institution is not permitted to include any capital in its core or supplementary capital unless the capital meets the essential characteristics applicable to core or supplementary capital specified in *section 22*. Furthermore, *sections 23* and *23A* and *Schedule 5* specify the deductions that an authorized institution shall make from its core and supplementary capital.

6. *Section 17* specifies the capital that constitutes the core capital of an authorized institution. However, the qualifications and restriction specified in *sections 17B*, *17C*, *17D*, *18A(5)*, *18B(2)* and *19(3)(a)* on various types of capital should be noted. *Section 18* specifies the capital that constitutes the supplementary capital of an authorized institution. However, the qualifications and restrictions specified in *sections 18A*, *18B*, *19*, *20* and *21* on various types of capital should be noted.

First draft (Second batch)

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

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(This Part is temporarily vacant)

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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 uplaced 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.	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 *Table 2* -	
	(a) commitments with an original maturity of up to and including one year;	20%
	(b) commitments with an original maturity of over one year;	50%
	(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,	0%
	where:	
	"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	

Table 1 - continued

	institution and the earliest date on which the institution can, at its option, unconditionally cancel the exposure.	

(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
1. Exchange rate contracts (other than an excluded exchange rate contract) -	
(a) with a residual maturity of up to and including one year;	1%
(b) with a residual maturity of over one year up to and including 5 years;	5%
(c) with a residual maturity of over 5 years,	7.5%
where:	
"excluded exchange rate contract" ( ) means –	
(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;	

Table 2 - continued

"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.	
2. Interest rate contracts -	
(a) with a residual maturity of up to and including one year;	0%
(b) with a residual maturity of over one year up to and including 5 years;	0.5%
(c) with a residual maturity of over 5 years.	1.5%

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

6. Credit derivative contracts consisting of -	
(a) credit default swaps booked in the trading book -	
(i) where the authorized institution is a protection buyer and the underlying reference [obligation] is -	
(A) a qualifying reference [obligation];	5%
(B) a non-qualifying reference [obligation];	10%
(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 –	
(A) a qualifying reference [obligation];	5%

Table 2 - continued

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

Table 2 - continued

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

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 *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

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

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.

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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.

Annex F

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SCHEDULE 1 Minimum criteria for approval under *section 4* of these Rules to use IMA to calculate market risk of authorized institution

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 -

"back-testing" ( ), in relation to the use by an authorized institution of the IMA to calculate its market risk, means a process whereby the actual daily changes in the value of a portfolio of exposures of the institution are compared with the daily VaR measures generated from the institution's internal model applicable to that portfolio;

"bonds" ( ), in relation to the calculation of an authorized institution's market risk, means interest-bearing or zero-coupon debt securities -

(a) which are acknowledgements of a debt promising payment of a specified sum to the holder of the debt securities; and

(b) which describe a time to maturity which is, or will become, definite;

"commodities" ( ), in relation to the calculation of an authorized institution's market risk, means any precious metals (other than gold), base metals, non-precious metals, energy or agricultural assets, or any other physical products which are, or can be, traded on an exchange;

"commodity-related derivative contract" ( ), in relation to the calculation of an authorized institution's market risk, means a futures contract, forward contract, swap contract, option contract or similar derivative contract the value of which is derived from the value of an underlying commodity;

"confidence interval" ( ) means a statistical range with a specified probability that a given parameter lies within the range;

"conversion factor" ( ) means a number published by a futures exchange for determining the price for each debt security deliverable against a bond futures contract;

"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");

"debt-related derivative contract" ( ), in relation to the calculation of an authorized institution's market risk, means a futures contract, forward contract, swap contract, option contract or similar derivative contract the value of which is derived from the value of an underlying debt security or index representing a basket of debt securities;

"debt securities" ( ), in relation to the calculation of an authorized institution's market risk, means -

(a) fixed and floating rate bonds;

(b) negotiable certificates of deposit;

(c) non-convertible preference shares;

(d) convertible bonds, preference shares, or other instruments, which trade like bonds, certificates or shares falling within *paragraph (a)*, *(b)* or *(c)*; and

(e) commitments to buy or sell any bonds, certificates, shares or instruments falling within *paragraph (a)*, *(b)*, *(c)* or *(d)*;

"delta" ( ), in relation to an option contract, means a measure of the sensitivity of the option contract's value to changes in the value of the underlying exposure of the option contract;

"delta-plus approach" ( ), in relation to the calculation of an authorized institution's market risk capital charge for its option exposures in debt securities, interest rates, equities, foreign exchange (including gold) and commodities, means the approach set out in *Division 9* of *Part 6*;

"delta-weighted position" ( ), in relation to an option contract, means the value of the underlying exposure of the option contract multiplied by the corresponding delta;

"derivative contract" ( ) means a financial instrument the value of which depends on the value of one or more than one underlying exposure;

"equities" ( ), in relation to the calculation of an authorized institution's market risk, means -

(a) ordinary shares (whether voting or non-voting);

(b) convertible bonds, preference shares, or other instruments, which trade like shares falling within *paragraph (a)*; and

(c) commitments to buy or sell any shares, bonds or instruments falling within *paragraph (a)* or *(b)*;

"equity-related derivative contract" ( ), in relation to the calculation of an authorized institution's market risk, means a futures contract, forward contract, swap contract, option contract or similar derivative contract the value of which is derived from the value of an underlying equity or a stock index;

"exceptions" ( ), in relation to back-testing by an authorized institution, means those instances in which the actual daily losses in the value of a portfolio of exposures of the institution are above the daily VaR measures generated from the institution's internal model applicable to that portfolio;

"exchange rate-related derivative contract" ( ), in relation to the calculation of an authorized institution's market risk, means a futures contract, forward contract, swap contract, option contract or similar derivative contract the value of which is derived from the value of an underlying currency (including gold);

"exempt" ( ), in relation to an authorized institution, means the institution is not required to calculate its market risk in accordance with *Part 6* or *6A* by virtue of an exemption under *section 10(1)*;

"fair value" ( ), in relation to a position of an authorized institution for the calculation of market risk, means -

(a) subject to *paragraph (b)*, the valuation by the institution of the position with reference to current market prices;

(b) in so far as the position relates to derivative contracts for which there are no readily available current market prices, the valuation by the institution of the derivative contracts based on -

(i) appropriate models; or

(ii) discounted cash flows using current market data;

"gamma" ( ), in relation to an option contract, means a measure of the rate of change in delta of the option contract to changes in the value of the underlying exposure of the option contract;

"general market risk" ( ), in relation to an authorized institution, means the risk of loss, arising from changes in interest rates, exchange rates, equity prices or commodity prices, to the institution's portfolio of exposures arising from its -

(a) trading book positions in debt securities, debt-related derivative contracts, interest rate derivative contracts, equities and equity-related derivative contracts; and

(b) positions in foreign exchange, exchange rate-related derivative contracts, commodities and commodity-related derivative contracts;

"HKD" ( ) means Hong Kong dollar;

"IMA" ( ), in relation to the calculation of an authorized institution's market risk, means the internal models approach;

"interest rate derivative contract" ( ), in relation to the calculation of an authorized institution's market risk, means a futures contract, forward contract, swap contract, option contract or similar derivative contract -

(a) the value of which varies in response to changes in interest rates; but

(b) the underlying exposure of which is neither a debt security nor an index representing a basket of debt securities;

"internal model" ( ), in relation to the use by an authorized institution of the IMA to calculate its market risk, means a statistical model used by the institution to measure the institution's market risk exposures;

"internal models approach" ( ), in relation to the calculation of an authorized institution's market risk, means the method of calculating that risk set out in *Part 6A*;

"investment grade" ( ) means credit quality grade 3 or lower derived from mapping the ECAI issuer rating of an issuer, being a sovereign, of any debt security, or from mapping the ECAI issue specific rating of any debt security issued by a bank, securities firm or corporate, to a scale of uniform credit quality grades set out in the tables in *Schedule [..]*;

"market risk capital charge" ( ), in relation to an authorized institution, means the amount of the institution's capital required to cover specific risk and general market risk;

"marking-to-model" ( ) means an approach to valuing an exposure, or a portfolio of exposures, where the value is benchmarked, extrapolated or calculated from an internal model based on a set of market data;

"matched positions" ( ), in relation to the calculation of an authorized institution's market risk, means 2 opposite positions held by the institution where the risk of loss arising from either position can be offset by the other position;

"maturity method" ( ) means the approach set out in *sections 20* and *20A* for the calculation of the market risk capital charge for general market risk in respect of interest rate exposures;

"parent bank" ( ), in relation to an authorized institution, means that bank, falling within *paragraph (b)* of the definition of "bank", of which the institution is a subsidiary;

"position" ( ), in relation to an authorized institution, means the holding or disposal by the institution of an exposure, or a portfolio of exposures, resulting in risk being taken by the institution on market price movements in respect of that exposure, or portfolio of exposures, as the case may be;

"recognized exchange" ( ) means -

(a) a recognized stock exchange; or

(b) a recognized futures exchange;

"recognized futures exchange" ( ) means a futures exchange listed in Part 2 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571);

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

"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 the settlement concerned is determined;

"risk category" ( ), in relation to the use by an authorized institution of the STM to calculate its market risk, means the category of the institution's market risk exposures which are at risk from -

(a) changes in debt security prices or interest rates;

(b) changes in exchange rates;

(c) changes in equity prices; or

(d) changes in commodity prices;

"simplified approach" ( ), in relation to the calculation of an authorized institution's market risk capital charge for its option exposures in debt securities, interest rates, equities, foreign exchange (including gold) and commodities, means the approach set out in *Division 8* of *Part 6*;

"specific risk" ( ), in relation to an authorized institution, means the risk of loss, arising from changes in the price of debt securities, debt-related derivative contracts, equities or equity-related derivative contracts, owing to factors relating to the issuers of debt securities or equities, or the issuers of the underlying debt securities or equities, as the case may be, to the institution's portfolio of exposures arising from it's trading book positions in those debt securities, debt-related derivative contracts, equities or equity-related derivative contracts, as the case may be;

"specific risk-free security" ( ) means a hypothetical debt security, free of specific risk, used for the calculation of the market risk capital charge for general market risk relating to derivative contracts;

"standardized approach" ( ), in relation to the calculation of an authorized institution's market risk, means the method of calculating that risk set out in *Part 6*;

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

"stress-testing" ( ), in relation to an authorized institution, means the use by the institution of a risk management technique to evaluate the potential impact on the institution of a specific event, or movements in a set of financial variables, or both, under stressed market conditions;

"trading day" ( ), in relation to the use by an authorized institution of the IMA to calculate its market risk, means a day on which a financial market is open for trading;

"USD" ( ) means United States dollar;

"value-at-risk" ( ), in relation to a portfolio of exposures, means a measure of the worst expected loss on the portfolio resulting from market movement over a period of time within a given confidence interval;

"VaR" ( ) means value-at-risk;

"vega" ( ), in relation to an option contract, means a measure of the sensitivity of the option contract's value to changes in the volatility of the value of the underlying exposure of the option contract.

PART 2

APPLICATION OF THESE RULES

3. Calculation of market risk

An authorized institution (other than an exempt authorized institution) shall -

(a) subject to *paragraphs (b)* and *(c)*, only use the STM to calculate its market risk;

(b) subject to *paragraph (c)* and *section 5*, only use the IMA to calculate its market risk if it has the approval to do so under *section 4(2)(a)*;

(c) if the institution is the subsidiary of a bank referred to in *paragraph (b)* of the definition of "bank", only use the approach adopted by its parent bank to calculate its market risk if it has the approval to do so under *section 7(2)(a)*.

4. Application by authorized institution for approval to use IMA to calculate its market risk

(1) An authorized institution may make an application to the Monetary Authority for approval to calculate its market risk by using the IMA.

(2) Subject to *subsection (3)* and *section 5*, the Monetary Authority shall determine an application under *subsection (1)* from an authorized institution by -

(a) granting approval to the institution to calculate its market risk by using the IMA; or

(b) refusing to grant such approval.

(3) Without limiting the generality of *subsection (2)(b)*, the Monetary Authority shall refuse to grant approval to an authorized institution to use the IMA to calculate its market risk if any one or more of the criteria specified in *Schedule 1* applicable to or in relation to the institution are not fulfilled with respect to the institution.

(4) Where an authorized institution uses the IMA to calculate its market risk, then the institution shall not, without the prior consent of the Monetary Authority, make any significant change to any internal model which was the subject of the approval under *subsection (2)(a)* which gave rise to the institution using the IMA to calculate its market risk.

5. Monetary Authority may grant approval to authorized institution to use IMA to calculate its market risk for parts only of its business, etc.

(1) The Monetary Authority may grant an approval under *section 4(2)(a)* to an authorized institution to use the IMA to calculate its market risk -

(a) in respect of general market risk, specific risk, or general market risk and specific risk, for -

(i) such risk categories as are specified in the approval; or

(ii) such local or overseas business of the institution as is specified in the approval; and

(b) beginning on such date, or the occurrence of such event, as is specified in the approval.

(2) For the avoidance of doubt, it is hereby declared that an authorized institution which has an approval under *section 4(2)(a)* falling within *subsection (1)* must use the STM to calculate its market risk in every case where it does not have approval to use the IMA to calculate its market risk.

6. Action that may be taken by Monetary Authority if authorized institution using IMA to calculate its market risk no longer fulfils criteria specified in *Schedule 1*

(1) Where -

(a) an authorized institution uses the IMA to calculate its market risk ; and

(b) the Monetary Authority is satisfied that, if the institution were to make a fresh application under *section 4(1)* for approval to use the IMA to calculate its market risk, such approval would be refused by virtue of *section 4(3)*,

then the Monetary Authority may, by notice in writing given to the institution -

(c) require the institution to use the STM to calculate its market risk instead of the IMA -

(i) in respect of all of its business, or parts of its business, as specified in the notice; and

(ii) beginning on such date, or the occurrence of such event, as is specified in the notice;

(d) advise the institution that the Monetary Authority is considering exercising the Monetary Authority's power under section 101 of the Ordinance to vary the capital adequacy ratio of the institution by increasing it;

(e) require the institution to calculate its market risk capital charge by the use of such higher multiplication factor as the Monetary Authority specifies pursuant to *section 41(2)*; or

(f) require the institution to adopt such measures specified in the notice which, in the opinion of the Monetary Authority, will cause the institution to cease to fall within *paragraph (b)* or will otherwise mitigate the effect of the institution falling within that paragraph.

(2) An authorized institution shall comply with a requirement referred to in *subsection (1)(c)*, *(e)* or *(f)* of a notice given to it under *subsection (1)*.

(3) For the avoidance of doubt, it is hereby declared that the criteria specified in *Schedule 1* are also applicable to and in relation to an authorized institution using the IMA to calculate its market risk in respect of the use by it of an internal model the subject of a significant change referred to in *section 4(4)* (and whether or not the institution has, in respect of that change, been given the prior consent referred to in *section 4(4)*), and *subsection (1)(b)* and the other provisions of this section shall apply to the institution accordingly.

7. Application by authorized institution for approval to use approach adopted by parent bank to calculate market risk

(1) An authorized institution which is the subsidiary of a bank referred to in *paragraph (b)* of the definition of “bank” may make an application to the Monetary Authority for approval to calculate its market risk by using the approach adopted by its parent bank to calculate market risk.

(2) Subject to *subsection (3)*, the Monetary Authority shall determine an application under *subsection (1)* from an authorized institution by -

(a) granting approval to the institution to calculate its market risk by using the approach adopted by its parent bank to calculate market risk; or

(b) refusing to grant such approval.

(3) Without limiting the generality of *subsection (2)(b)*, the Monetary Authority shall refuse to grant approval to an authorized institution to calculate its market risk by using the approach adopted by its parent bank to calculate market risk unless the institution satisfies the Monetary Authority that -

(a) that approach is not materially different from the STM or IMA, or any combination of both, to calculate the market risk of an authorized institution; and

(b) the parent bank is adequately supervised on a consolidated basis by the relevant banking supervisory authority (including so supervised in respect of capital adequacy, concentration of exposures and liquidity).

8. Action that may be taken by Monetary Authority if Monetary Authority ceases to be satisfied as specified in *section 7(3)*, etc.

(1) Where -

(a) an authorized institution is using the approach of its parent bank to calculate market risk; and

(b) the Monetary Authority is satisfied that, if the institution were to make a fresh application under *section 7(1)* for approval to use that approach to calculate its market risk, such approval would be refused -

(i) by virtue of *section 7(3)*; or

(ii) because the entity which was the parent bank of the institution has ceased to be the parent bank of the institution,

then the Monetary Authority may, by notice in writing given to the institution, revoke the approval concerned under *section 7(2)(a)* beginning on such date, or the occurrence of such event, as is specified in the notice.

(2) Immediately upon the revocation under *subsection (1)* of an approval under *section 7(2)(a)* granted to an authorized institution, *section 3(a)* and *(b)* shall apply to the institution.

9. Authorized institution which uses IMA to calculate market risk requires Monetary Authority's prior consent to use STM instead of IMA

Subject to *section 6(1)(c)*, an authorized institution which uses the IMA to calculate its market risk in respect of all or any part of its business pursuant to an approval under *section 4(2)(a)* shall not, in respect of such business, use the STM to calculate its market risk instead of the IMA except with the prior consent of the Monetary Authority.

10. Exemption from *section 3*

(1) The Monetary Authority shall exempt an authorized institution (other than an authorized institution using the IRB to calculate its credit risk) from *section 3* if the institution satisfies the Monetary Authority that -

(a) the institution's positions -

(i) never exceed 5% of its total on-balance sheet and off-balance sheet items; or

(ii) only sporadically exceed 5%, and never exceed 6%, of its total on-balance sheet and off-balance sheet items; and

(b) the institution's positions -

(i) never exceed $50 million; or

(ii) only sporadically exceed $50 million and never exceed $60 million.

(2) For the purposes of *subsection (1)* -

(a) the amount of an authorized institution's positions is calculated by aggregating -

(i) the institution's total gross (long plus short) positions in debt securities and debt-related derivative contracts;

(ii) the mean average of the institution's total long and total short positions in interest rate derivative contracts;

(iii) the institution's total gross (long plus short) positions in equities and equity-related derivative contracts;

(iv) the total net open position of the institution in foreign exchange exposures as set out in *section 28(1)*; and

(v) the institution's total gross (long plus short) positions in commodities and commodity-related derivative contracts;

and

(b) an authorized institution's total on-balance sheet and off-balance sheet items are derived by -

(i) aggregating the institution's total liabilities, total on-balance sheet assets less specific and collective provisions, and the principal amount of all of the institution's off-balance sheet exposures; and

(ii) deducting therefrom the institution's paid-up capital, reserves, current profit and loss, and perpetual or term subordinated debt.

(3) The positions applicable to an authorized institution for the purposes of *subsections (1)* and *(2)* shall be those positions as on -

(a) subject to *paragraph (b)*, the last calendar day of each of the 4 consecutive calendar quarters of the same calendar year; or

(b) the last calendar day of such other period, being not more than 4 consecutive calendar quarters, as the Monetary Authority specifies in writing in respect of the institution.

[(4) Where an authorized institution is exempted under this section from *section 3*, the institution -

(a) shall not, except with the prior consent of the Monetary Authority, include market risk in the calculation of its capital adequacy ratio (and the definition of "capital adequacy ratio" shall be construed accordingly);

(b) shall give notice in writing to the Monetary Authority of -

  (i) an increase in its positions which causes it, or may cause it, to cease to fall within *paragraphs (a)* and *(b)* of *subsection (1)*; or

  (ii) an intention to increase its positions which will cause it, or may cause it, to cease to fall within *paragraphs (a)* and *(b)* of *subsection (1)*; and

(c) shall, in the case of any of its market risk exposures that can also be treated as credit risk exposures of the institution, apply the provisions of [*Part 4*] to those market risk exposures.]

11. Revocation of exemption from *section 3*

(1) Where -

(a) an authorized institution is exempted under *section 10(1)* from *section 3*; and

(b) the Monetary Authority is satisfied that, if the institution were not already so exempted, such exemption would be refused by virtue of the institution failing to satisfy the Monetary Authority as specified in *section 10(1)*,

then the Monetary Authority may, by notice in writing given to the institution, revoke the exemption concerned under *section 10(1)* beginning on such date, or the occurrence of such event, as is specified in the notice.

(2) *Section 3* shall apply to an authorized institution immediately upon the revocation under this section of an exemption under *section 10(1)*.

PART 3

DETERMINATION OF CAPITAL BASE

(Not included in this set)

PART 4

CALCULATION OF CREDIT RISK

(Not included in this set)

PART 5

CALCULATION OF OPERATIONAL RISK

(Not included in this set)

PART 6

STANDARDIZED APPROACH TO CALCULATION OF MARKET RISK

Division 1 - General

11A. Application of *Part 6*, etc.

(1) This Part shall apply to an authorized institution which uses the STM to calculate its market risk.

(2) *Divisions 3*, *4*, *5* and *6* shall not apply to an authorized institution's option exposures in debt securities, interest rates, equities, foreign exchange (including gold) and commodities except to the extent, if any, specified in *Division 7*, *8* or *9*.

12. Positions to be used to calculate market risk

(1) Subject to *subsections (2)* and *(4)*, an authorized institution shall calculate its market risk to take into account the risk of losses arising from fluctuations in the value of its positions held -

(a) for trading purposes in -

(i) debt securities;

(ii) debt-related derivative contracts;

(iii) interest rate derivative contracts;

(iv) equities; and

(v) equity-related derivative contracts; and

(b) in -

(i) foreign exchange;

(ii) exchange rate-related derivative contracts;

(iii) commodities; and

(iv) commodity-related derivative contracts.

(2) An authorized institution shall not include a position in the calculation of its market risk if the position is -

(a) a recognized credit derivative contract in the institution's trading book as a hedge to a credit exposure in the banking book; or

(b) an exposure required to be deducted from the institution's capital base pursuant to *Part 3*.

(3) An authorized institution shall value its positions, whether based on a marking-to-market or marking-to-model methodology -

(a) in a prudent manner; and

(b) without prejudice to the generality of *paragraph (a)*, by taking into account the liquidity of the positions.

(4) Where the Monetary Authority is satisfied that an authorized institution has contravened *subsection (3)*, the Monetary Authority may, by notice in writing given to the institution, require the institution to reduce its positions -

(a) in respect of all of its positions, or such class of its positions, as specified in the notice;

(b) to the limit, if any, specified in the notice; and

(c) beginning on such date, or the occurrence of such event, as is specified in the notice.

[(5) Provision not used.]

(6) An authorized institution shall comply with the requirement of a notice given to it under *subsection (4)*.

(7) Where a position of an authorized institution does not fall into *subsection (1)* by virtue of *subsection (2)(a)*, then the institution shall include that position in the calculation of its credit risk.

(8) For the avoidance of doubt, it is hereby declared that nothing in this section shall operate to prejudice the generality of the Monetary Authority's powers under Part XVII of the Ordinance (including any case where the Monetary Authority is considering exercising the power under section 101 of the Ordinance in respect of an authorized institution that the Monetary Authority is satisfied has contravened *subsection (3)*).

[13. Provision not used]

14. Calculation of market risk capital charge for each risk category

(1) An authorized institution shall calculate in accordance with this Part the market risk capital charge for its exposures falling into each risk category.

(2) Subject to *subsection (3)*, an authorized institution shall use the fair value of its positions to calculate the market risk capital charge.

(3) Where the apparent notional amount of a leveraged instrument held by an authorized institution is different from the actual exposure amount of the instrument, then the institution shall use the actual exposure amount of the instrument for the purposes of this Part.

15. Calculation of risk-weighted amount

An authorized institution shall calculate its risk-weighted amount for market risk by multiplying the aggregate of the market risk capital charge as calculated pursuant to *section 14* by 12.5.

[*Division 2* - Division not used]

Division 3 **- Calculation of market risk capital charge for interest rate exposures**

[16. Calculation of market risk capital charge

An authorized institution shall, for the purposes of calculating the market risk capital charge for interest rate exposures -

(a) calculate in accordance with *section 17* the market risk capital charge for the specific risk of each of its trading book positions (whether long or short) in debt securities and debt-related derivative contracts; and

(b) calculate in accordance with *section 20* the market risk capital charge for the general market risk of -

(i) its trading book positions (whether long or short) in debt securities, debt-related derivative contracts and interest rate derivative contracts;

(ii) the interest rate exposures arising from its trading book positions (whether long or short) in equity-related derivative contracts; and

(iii) the interest rate exposures arising from its positions (whether long or short) in commodity-related derivative contracts.

17. Calculation of market risk capital charge for specific risk

(1) Subject to *subsections (2)* to *(8)*, an authorized institution shall for the purposes of calculating the market risk capital charge for specific risk for its positions (whether long or short) in debt securities and debt-related derivative contracts -

(a) assign those positions into the categories specified in *column 1* of *Table 1*, the credit quality grades specified in *column 2* of that table and, if applicable, the residual maturities specified in *column 3* of that table;

(b) multiply those positions by the appropriate market risk capital charge percentage for specific risk specified in *column 3* of that table; and

(c) calculate the total market risk capital charge for specific risk as the sum of the market risk capital charge for specific risk for each of those positions.

Table 1

Market risk capital charge for specific risk

Column 1	Column 2	Column 3
Categories	**Credit quality grade**	**Market risk capital charge percentage for specific risk**
Sovereign	1	0%
	2 or 3	0.25% (residual maturity 6 months or less)
		1.00% (residual maturity over 6 months and up to and including 24 months)
		1.60% (residual maturity over 24 months)
	4 or 5	8.00%
	6	12.00%
	Unrated	8.00%
Qualifying		0.25% (residual maturity 6 months or less)
		1.00% (residual maturity over 6 months and up to and including 24 months)
		1.60% (residual maturity over 24 months)
Non-qualifying	4	8.00%
	5	12.00%
	Unrated	8.00%

(2) An authorized institution shall not offset between positions referred to in *subsection (1)* for the purposes of that subsection except long and short positions in

identical issues (including positions in derivative contracts) with the same issuer, coupon, currency and maturity.

(3) For the purposes of *subsection (1)*, an authorized institution -

(a) if -

(i) the issuer of any debt securities referred to in that subsection or, in the case of debt-related derivative contracts referred to in that subsection, the issuer of the underlying debt securities, has a current ECAI issuer rating; or

(ii) any debt securities referred to in that subsection or, in the case of debt-related derivative contracts referred to in that subsection, any underlying debt securities, have a current ECAI issue specific rating,

shall, subject to *paragraphs (b)*, *(c)* and *(d)*, map the ECAI issuer rating or the ECAI issue specific rating, as the case may be, to a scale of uniform credit quality grades in accordance with the tables set out in *Schedule [..]*;

(b) [subject to *paragraph (f)*,] in the case of debt securities referred to in that subsection issued by a sovereign or, in the case of debt-related derivative contracts referred to in that subsection where the underlying debt securities are issued by a sovereign, shall determine the credit quality grade to be used by reference to the current ECAI issuer rating of that sovereign;

(c) [subject to *paragraph (e)*,] in the case of debt securities or debt-related derivative contracts referred to in that subsection that do not fall within *paragraph (b)*, shall determine the credit quality grade to be used by reference to, in the case of debt securities, the current ECAI issue specific rating of the debt securities or, in the case of debt-related derivative contracts, the current ECAI issue specific rating of the underlying debt securities;

(d) may only assign a risk-weight of 0% to -

(i) debt securities referred to in that subsection issued by a sovereign with a credit quality grade of 2 or 3 as determined under *paragraph (b)*; or

(ii) debt-related derivative contracts referred to in that subsection in respect of which the underlying debt securities are issued by a sovereign with a credit quality grade of 2 or 3 as determined under *paragraph (b)*,

if, and only if, those debt securities or, in the case of those debt-related derivative contracts, those underlying debt securities, are denominated in the domestic currency of that sovereign and funded by the institution in that currency;

(e) shall treat as unrated any debt securities or, in the case of debt-related derivative contracts, the underlying debt securities, referred to in *paragraph (c)* which do not have a current ECAI issue specific rating;

(f) shall treat as unrated the issuer of any debt securities or, in the case of debt-related derivative contracts, the issuer of any underlying debt securities, referred to in *paragraph (b)* which does not have a current ECAI issuer rating.

(4) An authorized institution may only include in the qualifying category in *Table 1* -

(a) debt securities issued by multilateral development banks and debt-related derivative contracts where the underlying debt securities are issued by multilateral development banks;

(b) debt securities, not falling within *paragraph (a)*, that are rated investment grade and debt-related derivative contracts where the underlying debt securities, not falling within *paragraph (a)*, are rated investment grade; and

(c) if the institution uses the IRB to calculate its credit risk, unrated debt securities, and debt-related derivative contracts if the underlying debt securities are unrated, where -

(i) the debt securities, or the underlying debt securities, as the case may be, are assessed as equivalent to investment grade under the institution's internal rating system on the basis that the debt securities, or the underlying debt securities, as the case may be, have a one-year probability of default of not more than the one-year probability of default implied

by the long-run average one-year probability of default of a debt security rated investment grade; and

(ii) the issuer of the debt securities, or the issuer of the underlying debt securities, as the case may be -

(A) has any debt or equity securities listed on a recognized stock exchange; or

(B) 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.

(5) Where any debt securities referred to in this section or, in the case of any debt-related derivative contracts referred to in this section, any underlying debt securities, have more than one current ECAI issue specific rating assigned to them, then an authorized institution shall, for the purposes of this section, apply *section [..]*, with all necessary modifications, to the ECAI issue specific ratings concerned to ascertain which one of them shall be used for those purposes.

(5A) Where the issuer of any debt securities referred to in this section or, in the case of any debt-related derivative contracts referred to in this section, the issuer of any underlying debt securities, has more than one current ECAI issuer rating assigned to the issuer, then an authorized institution shall, for the purposes of this section, apply *section [..]*, with all necessary modifications, to the ECAI issuer ratings concerned to ascertain which one of them shall be used for those purposes.

[(6) Where the Monetary Authority is satisfied that any of an authorized institution's market risk capital charge for specific risk is underestimated for any non-qualifying debt securities (being debt securities not falling within *subsection (4)*) or debt-related derivative contracts (being debt-related derivative contracts not falling within *subsection (4)*) referred to in this section that have a high yield to redemption relative to debt securities or debt-related derivative contracts falling within *subsection (3)(b)*, then the Monetary Authority may, by notice in writing given to the institution -

(a) require the institution to apply a higher market risk capital charge for specific risk to the first-mentioned debt securities or debt-related derivative contracts, as the case may be, as specified in the notice;

(b) prohibit offsetting, for the purposes of calculating the institution's market risk capital charge for general market risk, between the first-mentioned debt securities or debt-related derivative contracts and any other debt securities or debt-related derivative contracts.]

(7) An authorized institution shall comply with the requirements of a notice given to it under *subsection (6)*.

(8) This section shall not apply to interest rate derivative contracts.

[(9) In this section, "sovereign" ( ) includes a sovereign foreign public sector entity.]

[18. Provision not used.]

[**19. Provision not used.]**

20. Calculation of market risk capital charge for general market risk

(1) An authorized institution shall calculate the market risk capital charge for general market risk by -

(a) multiplying its long and short positions in interest rate exposures in each time band within the maturity ladder constructed in accordance with *section 20A* by the appropriate risk-weight as set out in *Table 3*;

(b) offsetting the total risk-weighted long and short positions in each time band to produce a single net risk-weighted long or short position for each time band;

(c) levying a 10% market risk capital charge ("vertical disallowance") on the matched position (being the lesser of the absolute values of the total risk-weighted long and short positions) of each time band, whether long or short;

(d) subject to *subsection (2)* -

(i) first conducting a round of horizontal offsetting between the net risk-weighted positions for the time bands in each of the 3 zones subject to a scale of disallowance factors, expressed as a fraction of the matched positions, as set out in *Table 2*;

(ii) then conducting a round of horizontal offsetting between the total net risk-weighted positions for each zone across the 3 zones (being between adjacent zones and between

zone 1 and zone 3) subject to a scale of disallowance factors, expressed as a fraction of the matched positions, as set out in *Table 2*; and

(e) applying 100% market risk capital charge for general market risk to the remaining net risk-weighted long or short position in interest rate exposures after carrying out the offsetting referred to in *paragraphs (b)* and *(d)*.

Table 2

Horizontal disallowance

	Time band		Horizontal disallowance factors		
Zones	**Coupon of not less than 3% per annum**	**Coupon of less than 3% per annum**	**Within the zone**	**Between adjacent zones**	**Between zones 1 and 3**
Zone 1	≤ 1 month	≤ 1 month	40%	40%	100%
	> 1 to 3 months	> 1 to 3 months			
	> 3 to 6 months	> 3 to 6 months			
	> 6 to 12 months	> 6 to 12 months			
Zone 2	> 1 to 2 years	> 1.0 to 1.9 years	30%		
	> 2 to 3 years	> 1.9 to 2.8 years			
	> 3 to 4 years	> 2.8 to 3.6 years		40%	
Zone 3	> 4 to 5 years	> 3.6 to 4.3 years	30%		
	> 5 to 7 years	> 4.3 to 5.7 years			
	> 7 to 10 years	> 5.7 to 7.3 years			
	> 10 to 15 years	> 7.3 to 9.3 years			
	> 15 to 20 years	> 9.3 to 10.6 years			
	> 20 years	> 10.6 to 12 years			
		> 12 to 20 years			
		> 20 years			

(2) For the purposes of -

(a) an authorized institution conducting horizontal offsetting under *subsection (1)(d)(i)*, the institution shall -

(i) calculate the net risk-weighted long or short position of each time band by separately adding -

(A) long positions to long positions; and

(B) short positions to short positions;

(ii) in the case of long and short positions in the same zone, subject the matched position (being the lesser of the absolute values of the total net risk-weighted long and short positions for the zone) to a market risk capital charge based on a horizontal disallowance factor of 40% for zone 1 and 30% for zone 2 and zone 3; and

(iii) offset the positions of time bands within the same zone to arrive at a total net risk-weighted long or short position for each zone;

(b) an authorized institution conducting horizontal offsetting under *subsection (1)(d)(ii)*, the institution shall -

(i) in the case of opposite positions between adjacent zones (being one zone having a total net risk-weighted long position while another zone has a total net risk-weighted short position), subject the matched position (being the lesser of the absolute values of the total net risk-weighted long position in one zone and the total net risk-weighted

short position in another zone) to a market risk capital charge based on a horizontal disallowance factor of 40%;

(ii) net off any offsetting positions between adjacent zones creating a matched position to which the horizontal disallowance factor has been applied and a total net risk-weighted long or short position;

(iii) subject to *subparagraph (iv)*, in the case of opposite positions between zone 1 and zone 3, subject the matched position (being the lesser of the absolute values of the total net risk-weighted long or short position in zone 1 and the total net risk-weighted short or long position respectively in zone 3) to a market risk capital charge based on a horizontal disallowance factor of 100%; and

(iv) in order to calculate the horizontal disallowance between zone 1 and zone 3 for the purposes of *subparagraph (iii)* -

(A) if the total net risk-weighted positions of zone 1 and zone 2 are netted, treat the net position as the remaining position of zone 1;

(B) if the total net risk-weighted positions of zone 2 and zone 3 are netted, treat the net position as the remaining position of zone 3.

(3) An authorized institution shall derive the market risk capital charge for general market risk for its portfolio of interest rate exposures by aggregating -

(a) the market risk capital charge for the remaining net risk-weighted long or short position calculated in accordance with *subsection (1)(e)*;

(b) the total market risk capital charge for vertical disallowance for all time bands calculated in accordance with *subsection (1)(c)*; and

(c) the total market risk capital charge for horizontal disallowance for individual zones and across different zones calculated in accordance with *subsection (1)(d)*.

(4) An authorized institution shall calculate the market risk capital charge for general market risk for each currency separately and then aggregate them for different currencies.

20A. Construction of maturity ladder

(1) Subject to *subsections (2)* to *(6)*, for the purposes of making the calculation required by *section 20(1)*, an authorized institution shall -

(a) slot all of its long or short positions in debt securities, debt-related derivative contracts, interest rate derivative contracts and interest rate exposures arising from equity-related derivative contracts and commodity-related derivative contracts with a coupon of not less than 3% per annum into a maturity ladder comprising the 13 time bands set out in *columns 1* and *2* of *Table 3*; and

(b) slot all of its long or short positions in debt securities, debt-related derivative contracts, interest rate derivative contracts and interest rate exposures arising from equity-related derivative contracts and commodity-related derivative contracts with a coupon of less than 3% per annum into a maturity ladder comprising the 15 time bands set out in *columns 1* and *3* of *Table 3*.

Table 3

Time bands and risk-weights

Column 1	**Column 2**	**Column 3**	**Column 4**
Time band	**Coupon of not less than 3% per annum**	**Coupon of less than 3% per annum**	**Risk-weight**
1	≤ 1 month	≤ 1 month	0.00%
2	> 1 to 3 months	> 1 to 3 months	0.20%
3	> 3 to 6 months	> 3 to 6 months	0.40%
4	> 6 to 12 months	> 6 to 12 months	0.70%
5	> 1 to 2 years	> 1.0 to 1.9 years	1.25%
6	> 2 to 3 years	> 1.9 to 2.8 years	1.75%
7	> 3 to 4 years	> 2.8 to 3.6 years	2.25%
8	> 4 to 5 years	> 3.6 to 4.3 years	2.75%
9	> 5 to 7 years	> 4.3 to 5.7 years	3.25%
10	> 7 to 10 years	> 5.7 to 7.3 years	3.75%
11	> 10 to 15 years	> 7.3 to 9.3 years	4.50%
12	> 15 to 20 years	> 9.3 to 10.6 years	5.25%
13	> 20 years	> 10.6 to 12 years	6.00%
14		> 12 to 20 years	8.00%
15		> 20 years	12.50%

(2) For the purposes of *subsection (1)*, an authorized institution shall -

(a) slot fixed rate exposures into the time bands set out in *Table 3* in accordance with their respective residual maturities;

(b) slot floating rate exposures into the time bands set out in *Table 3* in accordance with their respective residual term to the next interest fixing date;

(c) regard interest rate exposures arising from derivative contracts as long and short positions and slot such positions into the time bands set out in *Table 3* such that -

(i) interest rate futures contracts, interest rate forward contracts and forward rate agreements are treated as a combination of the long and short positions in a zero coupon specific risk-free security whereby -

(A) a long or short position in an interest rate futures contract or interest rate forward contract is to be regarded as -

(I) a short or long position respectively with a maturity being the remaining period up to and including the delivery date of the underlying interest rate contract; and

(II) a long or short position respectively with a maturity being the remaining period up to and including the delivery date of the underlying interest rate contract plus the contract period of the underlying interest rate contract; or

(B) a sold or purchased forward rate agreement is to be regarded as -

(I) a long or short position respectively with a maturity being the remaining period up to and including the settlement date of the agreement plus the contract period of the agreement; and

(II) a short or long position respectively with a maturity being the remaining period up to and including the settlement date of the agreement;

(ii) bond futures contracts and bond forward contracts are treated as a combination of the long and short positions in a zero coupon specific risk-free security and the underlying bond whereby -

(A) a long or short position in a bond futures contract or bond forward contract is to be regarded as -

(I) a short or long position respectively in a zero coupon specific risk-free security with a maturity being the remaining period up to and including the delivery date of the underlying bond; and

(II) a long or short position respectively in the underlying bond with a maturity being the remaining period up to and including the delivery date of the underlying bond plus the tenor of the underlying bond;

(iii) interest rate swap contracts under which the institution receives or pays floating rate interest and pays or receives respectively fixed rate interest are regarded as -

(A) a long or short position respectively in a floating rate instrument with a maturity being the remaining period up to and including the next interest fixing date; and

(B) a short or long position respectively in a fixed rate instrument with a maturity being the remaining period up to and including the maturity date of the swap contract concerned.

(3) For the purposes of *subsection (1)*, an authorized institution -

(a) may exclude from the maturity ladder long and short positions in identical instruments having the same issuer, coupon, currency and maturity;

(b) may fully offset a matched position in a futures contract or forward contract and the underlying exposure except that the position in a zero coupon specific risk-free security referred to in *subsection*

(2)(c)(ii)(A)(I) shall be included in the calculation of the institution's market risk capital charge for general market risk.

[(4) For the purposes of *subsection (1)*, an authorized institution -

(a) in the case of a futures contract or forward contract comprising a range of deliverable bonds, may only offset positions in the contract and the underlying bond which is readily identifiable as the most profitable for the institution with a short position to deliver;

(b) shall, after offsetting a futures contract or forward contract and the underlying bond pursuant to *paragraph (a)*, record the amount of the remaining long position of the contract, up to and including the delivery date of the contract, as the face value of the contract divided by the conversion factor applicable to the contract and multiplied by the current market price of that bond.]

(5) Subject to *subsection (6)*, for the purposes of *subsection (1)*, an authorized institution may treat opposite positions in the same type of derivative contract (including the delta-weighted position of option contracts calculated in accordance with *section 35*) as matched and may fully offset them.

(6) For the purposes of *subsection (5)*, positions in the same type of derivative contract are only opposite if -

(a) the positions relate to the same underlying exposures, are of the same nominal value and denominated in the same currency;

(b) in the case of futures contracts, the offsetting positions in the underlying interest rate exposures to which the futures contracts relate are for identical exposures and mature within 7 days of each other;

(c) in the case of swap contracts and forward rate agreements, the reference rates (for floating rate positions) are identical and the coupons are within 15 basis points; and

(d) in the case of swap contracts, forward rate agreements and forward contracts, the next interest fixing date or, for fixed coupon positions or forward contracts, the residual maturity, corresponds within the following limits -

    (i) if either of the contracts to be offset has an interest fixing date or residual maturity up to one month, the interest fixing date or residual maturity, as the case may be, is the same for both contracts;

    (ii) if either of the contracts to be offset has an interest fixing date or residual maturity greater than one month and up to and including one year, the dates or residual maturities, as the case may be, are within 7 days of each other; and

    (iii) if either of the contracts to be offset has an interest fixing date or residual maturity of more than one year, those dates or residual maturities, as the case may be, are within 30 days of each other.

[**21. Provision not used.]**

22. Use of alternatives requires Monetary Authority's prior consent

An authorized institution -

(a) shall use the methodology prescribed in this Division to calculate its positions to be included in the maturity ladder unless it has the prior consent of the Monetary Authority to use different methodology; and

(b) shall use the maturity method to calculate the market risk capital charge for general market risk for its portfolio of interest rate exposures unless it has the prior consent of the Monetary Authority to use a different method.

Division 4 - Calculation of market risk capital charge for equity exposures

23. Calculation of market risk capital charge

An authorized institution shall, for the purposes of calculating the market risk capital charge for its positions (whether long or short) in equities and equity-related derivative contracts in its trading book -

(a) calculate the market risk capital charge for specific risk for each of those positions; and

(b) calculate the market risk capital charge for general market risk for those positions.

24. Preliminary steps to calculating market risk capital charge

(1) For the purposes of *section 23*, an authorized institution shall -

(a) subject to *paragraph (b)*, make a separate calculation for each of its positions in equity exposures for each exchange where the equities concerned are listed or traded (“exchange-by-exchange basis”);

(b) if an equity is listed on more than one exchange, make the calculation referred to in *paragraph (a)* only in respect of that exchange which is the primary listing of the equity;

(c) convert its equity-related derivative contracts into positions in the underlying equity by -

(i) valuing its futures contracts and forward contracts relating to an individual equity at the fair value of the underlying equity;

(ii) valuing its futures contracts relating to equity indices as -

(A) the current index value multiplied by the monetary value of one index point set by the futures exchange where the futures contract is traded (“tick value”); or

(B) the fair value of the underlying equity portfolio;

(d) regard each of its equity swap contracts as long and short positions such that -

(i) in the case of an equity swap contract in which the institution -

(A) is receiving an amount based on the change in value of a particular equity or equity index; and

(B) is paying an amount based on the change in value of a different equity or equity index,

the position in *sub-subparagraph (A)* is the long position, and the position in *sub-subparagraph (B)* is the short position, of the equity swap contract; and

(ii) in the case of an equity swap contract which involves a position requiring the receipt or payment of fixed or floating rate interest, the institution treats the position under the maturity method;

(e) if equities are to be received or delivered under a forward contract, treat any interest rate exposure arising out of the contract under the maturity method; and

(f) in the case of an equity futures contract or an equity index futures contract, treat any interest rate exposure arising out of the contract under the maturity method.

(2) For the purposes of *section 23*, an authorized institution may -

(a) offset fully its matched positions in each identical equity or equity index with the same delivery month in each exchange in order to produce a single net short or long position;

(b) offset a futures contract in a given equity against an opposite position in the same equity.

25. Calculation of market risk capital charge for specific risk

Subject to *section 24*, an authorized institution shall calculate the market risk capital charge for specific risk for its trading positions in equities and equity-related derivative contracts as 8% on the total gross (long plus short) position.

26. Calculation of market risk capital charge for general market risk

(1) Subject to *section 24* and *subsection (2)*, an authorized institution shall calculate the market risk capital charge for general market risk for its trading positions in equities and equity-related derivative contracts as 8% on its total net position in equities and equity-related derivative contracts (being the difference between the sum of the institution's long positions and the sum of the institution's short positions).

(2) An authorized institution shall not, for the purposes of *subsection (1)*, offset net long and short positions on different exchanges.

Division 5 - Calculation of market risk capital charge for foreign exchange exposures (including gold)

27. Preliminary steps to calculating market risk capital charge

An authorized institution shall, for the purposes of calculating the market risk capital charge for its positions in foreign exchange (including gold) and exchange rate-related derivative contracts -

(a) determine the amount of its net open position (being the sum of the net spot position and the net forward position) in each currency and in gold;

(b) convert each amount determined under *paragraph (a)* into HKD at current market rates;

(c) [subject to [*Division 7*],] in relation to those positions arising from foreign currency option contracts, apply *paragraphs (a)* and *(b)* to each currency to which the option contracts relate; and

(d) not exclude any of its structural positions from such calculation except after consultation with the Monetary Authority.

28. Calculation of market risk capital charge

(1) Subject to *section 27* and *subsection (2)*, an authorized institution shall calculate the market risk capital charge for its foreign exchange exposures as 8% of the institution's total net open position derived by aggregating -

(a) the sum of the institution's net long or short positions less its USD position against its HKD position; and

(b) the institution's net position in gold (whether long or short).

[(2) For the purposes of *subsection (1)(a)* -

(a) the sum of an authorized institution's net long or short positions is the sum of -

(i) its total net long or short position in each foreign currency (including, if applicable, the net delta-weighted position of option contracts in each such currency); and

(ii) its HKD position to ensure that the total of all net long positions is the same as the total of all net short positions;

(b) the USD position against the HKD position in respect of an authorized institution is -

(i) zero if the institution's net open positions in USD and HKD are both long or both short;

(ii) the smaller of the 2 positions (expressed as the absolute value) if the institution's net open positions in USD and HKD are opposite positions.

Division 6 - Calculation of market risk capital charge for commodity exposures

29. Preliminary steps to calculating market risk capital charge

(1) An authorized institution shall, for the purposes of calculating the market risk capital charge for its positions in commodities and commodity-related derivative contracts -

(a) convert its gross (long plus short) position in each commodity to which those positions relate (measured in barrels, kilos or grams or such other standard unit of measurement as is applicable to the commodity concerned) into monetary terms at the current market price of the commodity;

(b) subject to *Division 7*, treat positions arising from commodity option contracts as commodity exposures;

(c) value a futures contract or forward contract relating to a commodity by reference to the notional amount of the standard unit of measurement of the commodity converted into monetary terms at current market price and apply the maturity method to any interest rate exposure arising out of that contract;

(d) in the case of a commodity swap contract under which one leg of the swap contract relates to a position or series of positions referenced to a fixed price and the other leg of the swap contract relates to a position or series of positions referenced to the current market price of a reference commodity or commodities -

(i) for each payment under the swap contract, value each of the positions at the notional amount of the swap contract;

(ii) treat each such position -

(A) as long if the institution is paying at a fixed price and receiving at a floating market price; and

(B) as short if the institution is receiving at a fixed price and paying at a floating market price; and

[(iii) treat any such leg which involves receiving or paying at a fixed or floating interest rate as an interest rate exposure to which the maturity method applies].

(2) An authorized institution -

(a) subject to *paragraph (b)*, may, for the purposes referred to in *subsection (1)*, offset long and short positions in each commodity when calculating its open positions;

(b) shall not so offset for its positions in different types of commodities.

30. Calculation of market risk capital charge

An authorized institution shall calculate the market risk capital charge for its commodity exposures as the sum of -

(a) 15% of the institution's net position in each commodity; and

(b) 3% of the institution's gross position (long plus short) in each commodity.

Division 7 - Calculation of market risk capital charge for option exposures

31. Approaches that authorized institution may use to calculate market risk capital charge for option exposures

An authorized institution shall, for the purposes of calculating the market risk capital charge for its option exposures in debt securities, interest rates, equities, foreign exchange (including gold) and commodities -

(a) subject to *section* 32 and *paragraph (c)*, use the simplified approach;

(b) subject to *section 34* and *paragraph (c)*, use the delta-plus approach; or

(c) with the prior consent of the Monetary Authority, use another approach.

Division 8 - Simplified approach

32. Application of *Division 8*

(1) An authorized institution shall not use the simplified approach to calculate the market risk capital charge for its option exposures unless the institution -

(a) purchases option contracts but does not write option contracts; or

[(b) purchases option contracts and only writes option contracts that are fully hedged by matched long positions in the same option contracts.]

(2) An authorized institution which uses the simplified approach to calculate the market risk capital charge for its option exposures shall -

(a) exclude from that calculation -

(i) option contracts written by it; and

(ii) the corresponding purchased option contracts fully hedged by the option contracts referred to in *subparagraph (i)*; and

(b) only use its outstanding purchased option contracts for that calculation.

33. Calculation of market risk capital charge for outstanding purchased option contracts

(1) An authorized institution shall calculate the market risk capital charge for its outstanding purchased option contracts (with and without related positions in the underlying exposures) -

(a) as set out in *Table 4*; and

(b) such that -

(i) the market risk capital charge is calculated separately for individual option contracts but together with the related position in the underlying exposure;

(ii) the institution uses the sum of the market risk capital charge for individual option contracts to calculate the total market risk capital charge for its portfolio of option exposures.

Table 4

Simplified approach

Position	Treatment
Long underlying exposure and long put option contract or Short underlying exposure and long call option contract	The market risk capital charge is the fair value of the underlying exposure of the option contract multiplied by the sum of the market risk capital charge percentages for general market risk and specific risk for the underlying exposure as specified in *Table 5* less the amount by which the option contract is in-the-money (if any). The market risk capital charge shall be zero if the above calculation produces a negative figure.
Long call option contract or long put option contract	The market risk capital charge shall be the lesser of - (a) the fair value of the underlying exposure of the option contract multiplied by the sum of the market risk capital charge percentages for general market risk and specific risk for the underlying exposure as specified in *Table 5*; or (b) the fair value of the option contract.

(2) Where it is unclear to an authorized institution which side of an option contract purchased by it is the underlying exposure, the institution shall take the exposure which would be received by it if the option under the contract were exercised.

(3) An authorized institution shall, for the purpose of calculating the market risk capital charge for an option contract purchased by it which has a residual maturity of more than 6 months -

(a) subject to *paragraph (b)*, compare the strike price of the option contract with the forward price, and not the current market price, of the underlying exposures of the option contract;

(b) if it is not practicable for the institution to comply with *paragraph (a)*, take the amount by which the option contract is considered to be in-the-money as zero.

(4) An authorized institution shall use the market risk capital charge percentages specified in *Table 5* for calculating the market risk capital charge of an option contract purchased by it.

Table 5

Market risk capital charge for each risk category

Risk category	**Market risk capital charge percentage for specific risk**	**Market risk capital charge percentage for general market risk**
Interest rate	As per the market risk capital charge percentages for specific risk in *Table 1* according to the issuer category, credit quality grade and residual maturity	As per the risk-weights in *Table 3* according to the residual maturity (for fixed rate instruments) or residual term to next interest fixing date (for floating rate instruments)
Equity	8.00%	8.00%
Foreign exchange	0.00%	8.00%
Commodity	0.00%	15.00%

(5) An authorized institution shall add the market risk capital charge calculated under this Division to the market risk capital charge calculated for the risk category concerned.

Division 9 - Delta-plus approach

34. Application of *Division 9*

An authorized institution which writes option contracts (other than such an authorized institution which, by virtue of *section 32(1)(b)*, uses the simplified approach to calculate the market risk capital charge) shall -

(a) incorporate the delta-weighted positions of its outstanding option contracts into their respective risk categories; and

(b) subject those positions to -

(i) market risk capital charge for general market risk and specific risk to cover delta risk;

(ii) market risk capital charge for gamma risk; and

(iii) market risk capital charge for vega risk.

35. Delta risk

An authorized institution shall, for the purposes of calculating its delta risk -

(a) slot its delta-weighted option positions which have debt securities or interest rates as the underlying exposures of the relevant option contracts into the time bands set out in *Table 3*;

(b) treat its interest rate option contracts as having long and short positions such that -

  (i) one position is referenced to the time the option contract concerned takes effect; and

  (ii) the other position is referenced to the time that the option contract matures;

(c) subject to *paragraph (d)*, calculate its market risk capital charge for option contracts with equities or equity indices as the underlying exposure by applying the calculation treatment under *Division 4* to the delta-weighted positions of those option contracts;

(d) for the purposes of *paragraph (c)*, treat equities or equity indices on each exchange as a separate underlying exposure;

(e) incorporate the net delta-weighted positions (being the difference between the institution's total delta-weighted long positions and its total delta-weighted short positions) of its foreign exchange and gold option contracts into the calculation of its market risk exposures for the respective foreign exchange and gold positions by applying the calculation treatment under *Division 5*; and

(f) incorporate the delta-weighted positions of its commodity option contracts into the calculation of its market risk exposures for the respective commodity positions by applying the calculation treatment under *Division 6*.

36. Gamma risk

(1) An authorized institution shall calculate the gamma impact of each of its option contracts by the use of *Formula 1*.

Formula 1

Calculation of gamma impact of option contracts

Gamma impact = $^{1}/_{2}$ x Gamma x VU^2

Where:

VU = variation of the underlying exposure of the option contract calculated as -

(a) for debt-related and interest rate option contracts, the fair value of that underlying exposure multiplied by the risk-weight for the appropriate time band set out in *Table 3*;

(b) for option contracts relating to equities and equity indices, the fair value of that underlying exposure multiplied by 8%;

(c) for option contracts relating to foreign exchange and gold, the fair value of that underlying exposure multiplied by 8%; and

(d) for option contracts relating to commodities, the fair value of that underlying exposure multiplied by 15%.

(2) For the purposes of *subsection (1)*, an authorized institution shall treat the following positions as the same underlying exposure -

(a) for interest rate exposures, positions within each time band as set out in *Table 3*;

(b) for equities and equity indices exposures, positions on each exchange;

(c) for foreign exchange and gold exposures, positions in each currency pair and gold; and

(d) for commodities exposures, positions in each individual commodity.

(3) An authorized institution shall -

(a) set-off the positive and negative gamma impacts for each option contract on the same underlying exposure to produce a positive or negative net gamma impact for that exposure; and

(b) only use negative net gamma impacts to calculate the market risk capital charge for gamma risk.

(4) An authorized institution shall calculate the total market risk capital charge for gamma risk as the sum of the absolute value of the net negative gamma impacts.

37. Vega risk

(1) An authorized institution shall calculate the market risk capital charge for vega risk by multiplying the sum of the vegas for all its option contracts on the same underlying exposure falling within *section 36(2)* by a proportional shift in volatility of ± 25%.

(2) An authorized institution shall calculate the total market risk capital charge for vega risk as the sum of the absolute value of the individual market risk capital charge for vega risk calculated under *subsection (1)*.

Division 10 - Capital treatment of credit derivative contracts in authorized institution's trading book

37A. Application of *Division 10*

This Division applies to credit derivative contracts in an authorized institution's trading book.

37B. Specific risk

(1) Where an authorized institution -

(a) has entered into a total return swap or credit default swap as the protection seller, the institution shall record a long position in the reference obligation specified in the contract;

[(b) has entered into a total return swap or credit default swap as the protection buyer, the institution shall record a short position in the reference obligation specified in the contract;]

(c) has purchased a credit-linked note, the institution shall record a long position in -

(i) the reference obligation of the note; and

(ii) the note issuer;

(d) has issued a credit-linked note, the institution shall record a short position in the reference obligation of the note;

(e) is -

(i) the protection buyer of a first-to-default credit derivative or the issuer of a credit-linked note and

(ii) does not hold any long position in an underlying exposure of the derivative contract or note, as the case may be,

the institution shall record a short position in one of the reference obligations in the basket of reference obligations under the derivative contract or under the note only (being the reference obligation with the highest market risk capital charge for specific

risk among the various reference obligations in the basket of reference obligations under the derivative contract or under the note);

(f) is the protection buyer of a first-to-default credit derivative or the issuer of a credit-linked note, the institution may offset the market risk capital charge for specific risk for the institution’s long position in the underlying exposure against the market risk capital charge for specific risk for the institution's short position in that one of the reference obligations in the basket of reference obligations under the derivative contract or under the note, as the case may be, that yields the lowest market risk capital charge for specific risk for all of the reference obligations in the derivative contract or under the note, as the case may be;

(g) subject to *subsection (2)*, is the protection seller of a first-to-default credit derivative or the purchaser of a credit-linked note, the institution shall record long positions in each of the reference obligations in the basket of reference obligations under the derivative contract or under the note, as the case may be, with the total market risk capital charge for specific risk for the derivative contract or the note, as the case may be, [capped] at the maximum liability under the derivative contract or the value of the note, as the case may be;

(h) enters into a credit default swap, total return swap or credit-linked note which provides for payment to be made by reference to multiple

reference obligations under a proportionate structure in specified proportions, the institution shall record its positions in the reference obligations according to their respective proportions in the credit default swap or total return swap, or under the note, as the case may be;

(i) has purchased or issued a credit-linked note which is referenced to multiple reference obligations and meets the conditions for a qualifying debt security or debt-related derivative contract set out in *section 17(4)*, the institution may -

(i) if it has purchased the note, record the specific risk arising from its long positions in the multiple reference obligations under the note as a single long position in the note;

(ii) if it has issued the note, record the specific risk arising from its short positions in the multiple reference obligations under the note as a single short position in the note.

(2) An authorized institution is not required to comply with *subsection (1)(g)* in respect of a first-to-default credit derivative or credit-linked note if it demonstrates to the satisfaction of the Monetary Authority that there is a very strong correlation among the reference obligations in the basket of reference obligations under the derivative contract or under the note, as the case may be.

37C. Use of credit protection provided by credit derivative contracts to offset

(1) Subject to *subsection (2)*, an authorized institution may use credit protection provided by a credit derivative contract in the institution's trading book to offset the market risk capital charge for specific risk calculated for the institution's trading book position in the underlying exposure of the credit derivative contract, or in another credit derivative contract, in accordance with *sections 37D*, *37E* and *37F*.

(2) Where *section 37D*, *37E* or *37F* does not permit an authorized institution to use credit protection provided by a credit derivative contract in the institution's trading book to offset the market risk capital charge for specific risk calculated for the institution's trading book position in the underlying exposure of the credit derivative contract, or in another credit derivative contract, then the institution shall provide the market risk capital charge against both trading book positions.

37D. Offsetting in full

(1) An authorized institution may offset in full its position under a credit derivative contract against a position in the underlying exposure of the derivative contract, or against a position in another credit derivative contract, for the purpose of calculating the market risk capital charge for specific risk if the values of the 2 positions, being the long or short position in the derivative contract, and the short or long position respectively in the underlying exposure of the derivative contract or the short or long position respectively in the other credit derivative contract, always move in the opposite direction and broadly to the same extent due to -

(a) the 2 positions consisting of identical exposures; or

(b) a long position in the underlying exposure being hedged by a total return swap (or vice versa) and there being a match between the reference obligation and the underlying exposure in every respect, and notwithstanding that the maturity of the total return swap may be different from that of the underlying exposure.

(2) Where an authorized institution has offset in full its position under a credit derivative contract against a position in the underlying exposure of the derivative contract, or against a position in another credit derivative contract, pursuant to *subsection (1)*, then no market risk capital charge [for specific risk] is required in respect of those positions.

37E. Offsetting by 80%

(1) An authorized institution may offset 80% of the market risk capital charge for specific risk for its position in a credit derivative contract against a position in the underlying exposure of the derivative contract where -

(a) the values of the 2 positions, being a long or short position in the derivative contract and a short or long position respectively in the underlying exposure of the derivative contract, always move in the opposite direction but not broadly to the same extent; and

(b) the institution has demonstrated to the Monetary Authority's satisfaction that the derivative contract can provide credit protection to the institution effectively.

(2) For the purposes of the demonstration referred to in *subsection (1)(b)* -

(a) subject to *paragraphs (b)*, *(c)* and *(d)*, an authorized institution falls within that subsection in any case where the institution's long position in the underlying exposure referred to in that subsection is effectively hedged by a credit default swap or credit-linked note (or vice versa);

(b) there is a match between -

(i) the reference obligation and the underlying exposure;

(ii) the maturity of the reference obligation and the credit derivative contract and of the underlying exposure; and

(iii) the denominated currency of the reference obligation and of the underlying exposure;

(c) the credit event definitions and settlement mechanisms and other key factors of the credit derivative contract do not cause the price movement of the contract to materially deviate from the price movements of the underlying exposure; and

(d) the credit derivative contract transfers risk effectively taking account of restrictive payout provisions (including fixed payouts and materiality thresholds).

(3) Where an authorized institution offsets its positions in a credit derivative contract pursuant to *subsection (1)* -

(a) only 20% of the market risk capital charge for specific risk is required for the position with the higher market risk capital charge for specific risk; and

(b) the market risk capital charge for specific risk for the other position shall be 0%.

37F. Other offsetting

(1) An authorized institution may offset partially the market risk capital charge for specific risk for its position under a credit derivative contract against a position in the underlying exposure of the derivative contract where the values of the 2 positions, being the long or short position in the derivative contract and the short or long position respectively in the underlying exposure of the derivative contract, usually move in the opposite direction in any case where -

(a) the position falls within *section 37D(1)(b)* but for there being an asset mismatch between the reference obligation and the underlying exposure (being that the reference obligation and the underlying exposure are similar but not identical) and -

(i) the reference obligation of the 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 legal entity as the obligor for the reference obligation and legally enforceable cross default or cross acceleration clauses are included in the terms of both the underlying exposure and the reference obligation;

(b) the position falls within *section 37D(1)(a)* or *37E* but for there being a currency or maturity mismatch between the derivative contract and the underlying exposure; or

(c) the position falls within *section 37E* but for there being an asset mismatch between the underlying exposure and the reference obligation under the derivative contract, being that the reference obligation and the underlying exposure, although similar, are not identical and the underlying exposure is included in one of the deliverable obligations in the derivative contract.

(2) Where an authorized institution offsets its positions in a credit derivative contract pursuant to *subsection (1)* -

(a) the position with the higher market risk capital charge for specific risk shall be subject to a partial allowance to reflect the extent of the offsetting but, in any case, not higher than 80%; and

(b) the market risk capital charge for specific risk for the other position shall be 0%.

37G. General market risk

Where an authorized institution -

(a) has entered into a total return swap as the protection seller, the institution shall -

(i) record a long position in the reference obligation specified in the swap contract;

(ii) where there are periodic interest payments under the swap contract, record a short position in a specific risk-free security with fixed or floating rate interest according to the payment terms of the swap contract;

(b) has entered into a total return swap as the protection buyer, the institution shall -

(i) record a short position in the reference obligation specified in the swap contract;

(ii) where there are periodic interest payments under the swap contract, record a long position in a specific risk-free security with fixed or floating rate interest according to the payment terms of the swap contract;

(c) has entered into a credit default swap with no periodic premiums or interest payments under the swap contract, the institution is not required to calculate the market risk capital charge for general market risk for the swap contract;

(d) has entered into a credit default swap as the protection seller with periodic premiums or interest payments under the swap contract, the institution shall record a long position in a specific risk-free security with fixed or floating rate interest according to the payment terms of the swap contract;

(e) has entered into a credit default swap as the protection buyer with periodic premiums or interest payments under the swap contract, the institution shall record a short position in a specific risk-free security with fixed or floating rate interest according to the payment terms of the swap contract;

(f) has purchased a credit-linked note, the institution shall record a long position in the note itself;

(g) has issued a credit-linked note, the institution shall record a short position in the note itself.

[37H. Counterparty credit risk

(1) An authorized institution which has entered into a total return swap as the protection buyer or the protection seller shall calculate the amount of capital required to cover the counterparty credit risk ("credit risk capital charge") for its position under the swap contract.

(2) Where an authorized institution -

(a) has entered into a credit default swap as the protection buyer, the institution shall calculate the credit risk capital charge for its position under the swap contract;

(b) has entered into a credit default swap as the protection seller with no periodic premiums or interest payments under the swap contract, the institution is not required to have any credit risk capital charge for the swap contract;

(c) has entered into a credit default swap as the protection seller with periodic premiums or interest payments under the swap contract, the institution shall calculate the credit risk capital charge for the outstanding amount of the premiums or interest payments, as the case may be, of the swap contract.

(3) For the avoidance of doubt, it is hereby declared that -

(a) there is no counterparty credit risk for an authorized institution as the purchaser or issuer of a credit-linked note;

(b) *section [..]* [of STC, IRB or BSA, as the case may be,] applies in the case of an authorized institution's counterparty credit risk under credit derivative contracts in the institution's trading book.]

37I. Foreign exchange risk

Where an authorized institution has entered into a credit derivative contract denominated in a currency other than HKD, the institution shall apply the capital requirements of *Division 5* to its [foreign exchange] position under the contract.

PART 6A

INTERNAL MODELS APPROACH TO CALCULATION OF MARKET RISK

Division 1 - General

38. Application of *Part 6A*

This Part shall apply to an authorized institution which uses the IMA to calculate its market risk.

38A. Positions to be used to calculate market risk

(1) Subject to *subsections (2)* and *(4)*, an authorized institution shall calculate its market risk to take into account the risk of losses arising from fluctuations in the value of its positions held -

(a) for trading purposes in -

(i) debt securities;

(ii) debt-related derivative contracts;

(iii) interest rate derivative contracts;

(iv) equities; and

(v) equity-related derivative contracts; and

(b) in -

(i) foreign exchange;

[(ii) exchange rate-related derivative contracts;]

(iii) commodities; and

(iv) commodity-related derivative contracts.

(2) An authorized institution shall not include a position in the calculation of its market risk if the position is -

(a) a recognized credit derivative contract in the institution's trading book as a hedge to a credit exposure in the banking book; or

(b) an exposure required to be deducted from the institution's capital base pursuant to *Part 3*.

(3) An authorized institution shall value its positions, whether based on a marking-to-market or marking-to-model methodology -

(a) in a prudent manner; and

(b) without prejudice to the generality of *paragraph (a)*, by taking into account the liquidity of the positions.

(4) Where the Monetary Authority is satisfied that an authorized institution has contravened *subsection (3)*, the Monetary Authority may, by notice in writing given to the institution, require the institution to reduce its positions -

(a) in respect of all of its positions, or such class of its positions, as specified in the notice;

(b) to the limit, if any, specified in the notice; and

(c) beginning on such date, or the occurrence of such event, as is specified in the notice.

[(5) Provision not used.]

(6) An authorized institution shall comply with the requirement of a notice given to it under *subsection (4)*.

(7) Where a position of an authorized institution does not fall into *subsection (1)* by virtue of *subsection (2)(a)*, then the institution shall include that position in the calculation of its credit risk.

(8) For the avoidance of doubt, it is hereby declared that nothing in this section shall operate to prejudice the generality of the Monetary Authority's powers under Part XVII of the Ordinance (including any case where the Monetary Authority is considering exercising the power under section 101 of the Ordinance in respect of an authorized institution that the Monetary Authority is satisfied has contravened *subsection (3)*).

39. [General]

(1) An authorized institution shall calculate the risk-weighted amount of its market risk exposures as the sum of -

(a) the market risk capital charge for general market risk calculated by the institution's internal model; and

(b) [where applicable,] the market risk capital charge for specific risk calculated by the institution's internal model,

multiplied by 12.5.

(2) Where an authorized institution uses one internal model to calculate the market risk capital charge for general market risk and specific risk, then the institution shall, in that calculation -

(a) subject to *subsection (3)*, use the higher of -

(i) the institution's VaR amount for all risk categories as at the last trading day; or

(ii) the average VaR amount for the last 60 trading days times the multiplication factor set out in *section 41*; and

(b) if applicable, apply a capital surcharge for default risk calculated in accordance with *section 40(2)*, *(3)* and *(4)* [as read with *section 4(e)* of *Schedule 1*].

(3) Where an authorized institution uses one internal model to calculate the market risk capital charge for general market risk and another internal model to calculate the market risk capital charge for specific risk, then the institution shall apply *subsection (2)(a)* separately to the VaR amount generated from each model.

40. Market risk capital charge for specific risk

[(1) Provision not used.].

(2) An authorized institution -

[(a) *paragraph* not used.]

(b) may, to avoid double counting, when calculating the [default risk in its positions], take into account the extent to which default risk has already been incorporated into the institution's internal model (in particular, for positions that would be closed out within 10 trading days in the event of adverse market conditions or other indications of deterioration in the credit environment).

(3) The default risk referred to in *section 4(e)* of *Schedule 1* shall not be treated as having been captured through a surcharge unless the authorized institution concerned satisfies the Monetary Authority that the surcharge provides sufficient capital to cover that default risk in respect of the institution's positions.

(4) Where an authorized institution captures the default risk referred to in *section 4(e)* of *Schedule 1* through a surcharge, then the surcharge shall not be subject to -

(a) a multiplication factor; or

(b) back-testing.

41. Multiplication factor

(1) The multiplication factor to be used by an authorized institution shall be the sum of -

(a) the value of 3;

(b) the plus factor, ranging from zero to one, based on -

(i) the number of back-testing exceptions for the last 250 trading days derived from *Table 6*; or

(ii) considerations which satisfy the Monetary Authority that any increase in back-testing exceptions is temporary; and

(c) any additional plus factor assigned to the institution pursuant to *subsection (2)*.

(2) Where -

(a) an authorized institution uses the IMA to calculate its market risk; and

(b) the Monetary Authority is satisfied that the institution has ceased to fulfil any of the criteria specified in *Schedule 1* applicable to or in relation to the institution,

then the Monetary Authority may, by notice in writing given to the institution, assign an additional plus factor to the institution.

Table 6

Plus factor for back-testing exceptions

Zone	Number of exceptions out of 250 observations	Plus factor
Green zone	Fewer than 5	0.00
Yellow zone	5	0.40
	6	0.50
	7	0.65
	8	0.75
	9	0.85
Red zone	10 or more	1.00

[42 to 48. Provisions not used.]

Division 2 - Capital treatment of credit derivative contracts in authorized institution's trading book

[49. IMA to calculation of market risk

(1) An authorized institution shall comply with *Division 1* and *Schedule 1* to apply the IMA to calculate the market risk capital charge for credit derivative contracts in its trading book.

(2) An authorized institution which does not use the IMA to calculate the market risk capital charge for credit derivative contracts in its trading book shall use the STM to calculate those charges as set out in *Division 10* of *Part 6*.]

[50. Counterparty credit risk

(1) An authorized institution which has entered into a total return swap as the protection buyer or the protection seller shall calculate the amount of capital required to cover the counterparty credit risk ("credit risk capital charge") for its position under the swap contract.

(2) Where an authorized institution -

(a) has entered into a credit default swap as the protection buyer, the institution shall calculate the credit risk capital charge for its position under the swap contract;

(b) has entered into a credit default swap as the protection seller with no periodic premiums or interest payments under the swap contract, the institution is not required to have any credit risk capital charge for the swap contract;

(c) has entered into a credit default swap as the protection seller with periodic premiums or interest payments under the swap contract, the institution shall calculate the credit risk capital charge for the outstanding amount of the premiums or interest payments, as the case may be, of the swap contract.

(3) For the avoidance of doubt, it is hereby declared that -

(a) there is no counterparty credit risk for an authorized institution as the purchaser or issuer of a credit-linked note;

(b) *section [..]* [of STC, IRB or BSA, as the case may be,] applies in the case of an authorized institution's counterparty credit risk under credit derivative contracts in the institution's trading book.]

[51. Foreign exchange risk

Where an authorized institution has entered into a credit derivative contract denominated in a currency other than HKD, the foreign exchange risk of the institution under the contract shall be subject to the capital requirements set out in *Division 1* of *Part 6A*.]

SCHEDULE 1

[*ss. 4 & 6*]

MINIMUM CRITERIA FOR APPROVAL UNDER *SECTION 4* OF THESE RULES TO USE IMA TO CALCULATE MARKET RISK OF AUTHORIZED INSTITUTION

General

1. The Monetary Authority is satisfied that the authorized institution's market risk management system is -

   (a) suitable for the purpose of identifying, measuring and controlling the institution's market risk taking into account the characteristics and extent of the institution's market risk exposures; and

   (b) operated in a prudent and consistently effective manner.

Qualitative criteria

2. Without [limiting] the generality of *section 1*, the Monetary Authority is satisfied that -

   (a) the board of directors and senior management of the authorized institution exercise sufficient oversight of the institution's market risk control process as will enable them to ensure that the process will achieve its objectives;

   (b) regular reports on the authorized institution's market risk profile are submitted to the institution's board of directors and senior management for review purposes;

(c) the authorized institution has a risk control unit, functionally independent from the institution's personnel and management responsible for originating and trading market risk exposures, which -

(i) is responsible for -

(A) designing and implementing, or selecting, the institution's risk management system;

(B) producing and analysing daily reports based on the output of the institution's internal models the subject of the application ("relevant models");

(C) conducting a regular back-testing programme to verify the accuracy and reliability of the relevant models; and

(D) conducting the initial and ongoing validation of the relevant models; and

(ii) reports directly to the institution's senior management;

(d) the authorized institution has a sufficient number of staff with experience and expertise in the use of the relevant models in the institution's trading, risk control, audit and back office units as will enable the units to function effectively in identifying, measuring and controlling the institution's market risk exposures;

(e) the use of the relevant models forms an integral part of the authorized institution's daily risk management process, the VaR

measures generated from the relevant models are used in determining the institution's trading and exposure limits and the relationship between the relevant models and those limits is consistent over time and understood by the institution's staff engaged in trading activity and its senior management;

(f) the authorized institution undertakes a regular and comprehensive stress-testing programme and the results of stress tests are -

(i) reported routinely to the institution's senior management and periodically to the institution's board of directors or its designated committee; and

(ii) taken into account in -

(A) setting the institution's policies and trading and exposure limits; and

(B) performing the institution's internal assessment of adequacy of the capital held by the institution, or other financial resources available to the institution, to withstand future events, or changes in market conditions, that could have adverse effects on its market risk exposures;

(fa) the authorized institution properly documents its internal policies, controls and procedures relating to the operation of the relevant models;

(g) the authorized institution has -

(i) a system for monitoring and ensuring compliance with its documented internal policies, controls and procedures concerning the operation of the relevant models; and

(ii) a well-documented manual on the relevant models that describes the basic principles of the institution's risk management system and provides an explanation of the empirical techniques used to measure market risk;

(h) the authorized institution has policies and procedures to ensure that the valuation of its positions is prudently made whenever there are uncertainties affecting the accuracy of valuation estimates;

(i) an independent review of the market risk management system is carried out regularly in the authorized institution's internal auditing process and covers both the activities of the institution's trading units and of the risk control unit;

(j) the relevant models have a proven track record of acceptable accuracy in measuring market risk;

(k) the authorized institution has processes in place to ensure that the relevant models are adequately validated -

(i) by parties -

(A) who possess relevant experience and expertise and who are independent of the development of the relevant models; and

(B) whose aim is to ascertain whether or not the relevant models are conceptually sound and able to capture all material market risk;

(ii) when a relevant model is initially developed and when any significant changes are made to the relevant model; and

(iii) on a periodic basis or when there have been significant structural changes in the market or changes to the composition of the institution's portfolio of exposures which might lead to the relevant model concerned no longer being adequate to capture all material market risk;

(l) the authorized institution has -

(i) adequate model validation procedures to assess the relevant models;

(ii) procedures to ensure that both the assumptions and approximations underlying the relevant models are appropriate for the measurement of the institution's market risk exposures; and

(iii) appropriate methods of assessing the validity of the performance of, and the results generated by, the relevant models and does not rely purely on the results of back-testing; and

(m) the relevant models capture and accurately reflect, on a continuing basis, all material market risk factors inherent in the authorized institution's market risk exposures.

Quantitative criteria

3. Without limiting the generality of *section 1*, the Monetary Authority is satisfied that -

(a) in respect of the relevant models -

(i) VaR is computed on a daily basis;

(ii) a one-tailed 99% confidence interval is used in calculating VaR;

(iii) the minimum holding period used by, or assumed by, the relevant models is 10 trading days in respect of the authorized institution's portfolio of exposures;

(iv) subject to *subparagraph (va)*, the historical observation period for calculating VaR is not less than 250 trading days;

(v) if the institution uses a weighting scheme to the historical observations for the calculation of VaR, a higher weighting is assigned to recent observations;

[(va) the institution is able to use a shorter observation period for the calculation of VaR if the Monetary Authority requests it to do so on the ground that the Monetary Authority is of the opinion that the request is justified due to a significant

increase in volatility in the price of the institution’s portfolio of exposures;]

(vi) data used are updated at least once every 3 months and are reassessed whenever market prices are subject to material changes;

(vii) the relevant models only recognize empirical correlations within and across risk categories if the institution's system for identifying and measuring correlations is effective for its purpose and implemented in a prudent manner; and

(viii) the relevant models accurately capture the unique risks associated with options exercisable under option contracts and, in particular -

(A) the relevant models are able to estimate the non-linear price movements of the institution's positions under those contracts;

(B) in calculating VaR, a price shock (being an instantaneous 10-day movement in prices) is applied to the institution's option positions or positions that display option-like characteristics or, if the institution is unable to perform a full 10-day price shock, the institution is able to use periodic simulation or stress-testing to adjust the capital requirement for such positions;

[(C) paragraph not used.]

(D) the relevant models are able to estimate the vega risk of the institution's option positions; and

(E) if the institution's portfolio of option exposures is relatively large or complex, the institution is able to estimate in detail the volatility of option positions at different maturities; and

[(b) paragraph not used.]

Additional criteria relating to models for the calculation of market risk capital charge for specific risk

4. Without [limiting] the generality of *section 1*, the Monetary Authority is satisfied that, if the authorized institution uses the relevant models to calculate the market risk capital charge for specific risk, then -

(a) the relevant models capture all material components of market risk and are responsive to changes in market conditions and the composition of the institution's portfolios of exposures and, in particular -

(i) are capable of providing a justification for the historical price variation in the portfolios;

(ii) are sensitive to changes in portfolio construction and require higher market risk capital charge for portfolios that have increased concentrations in particular issuers or sectors of exposures;

(iii) are able to signal rising market risk in an adverse environment;

(iv) are sensitive to material idiosyncratic differences between similar but not identical positions (including debt positions with different levels of subordination, maturity mismatches, or credit derivative contracts with different credit events);

(v) are able to capture events that are reflected in large changes in prices ("event risk"); and

(vi) are validated through back-testing aimed at assessing whether specific risk is being captured adequately;

(b) if the institution is subject to event risk that is not reflected in its VaR measure because it is outside the 10-day holding period and 99% confidence interval, the institution has ensured that the impact of event risk is factored into its internal assessment process through stress-testing as referred to in *section 2(f)*;

(c) the relevant models conservatively assess the risk arising from less liquid positions and positions with limited price transparency under realistic market scenarios;

(d) proxies are only used, for positions referred to in *paragraph (c)* -

(i) where available data are insufficient or not reflective of the true volatility of an exposure or portfolio of exposures;

(ii) which are conservative; and

(iii) conservatively;

(e) the institution has, for the purposes of calculating the market risk capital charge, an approach -

    (i) to separately capture the default risk of its trading book positions if the institution cannot capture, or adequately capture, such risk in the relevant models; and

    (ii) comprised within the relevant models or in the form of a surcharge separately calculated by the institution; and

(f) the institution is able to demonstrate that it meets the qualifying standards comparable to those of the IRB for the calculation of credit risk, with any necessary adjustments to reflect the impact of liquidity, concentrations and hedging on, and the option characteristics of, its exposures.

EXPLANATORY NOTE

(Market Risk only)

Part 2 - Application of these Rules

1. *Section 3* specifies that an authorized institution must use the standardized approach ("STM") to calculate its market risk (see *Part 6*) unless it has the approval of the MA to use the internal models approach ("IMA") to calculate its market risk (see *Part 6A*). However, *section 3* also provides that if an authorized institution is a subsidiary of a bank ("parent bank") referred to in *paragraph (b)* of the definition of "bank", then it may use the approach adopted by the parent bank to calculate its market risk if it has the MA's approval to do so. Finally, *section 3* does not apply to an exempt authorized institution (see the definition of "exempt" in *section 2(1)*).

2. *Section 4* specifies that the MA shall refuse to grant approval to an authorized institution to use the IMA to calculate its market risk if any of the criteria specified in *Schedule 1* are not fulfilled with respect to the institution. *Section 5* provides that an approval under *section 4* to use the IMA may be given to an authorized institution in respect of, *inter alia*, the institution's general market risk or specific risk (see the definitions of "general market risk" and "specific risk", in *section 2(1)*) or all of the institution's market risk. *Section 6* specifies the action

that may be taken by the MA where an authorized institution using the IMA no longer fulfils the criteria specified in *Schedule 1*.

3. *Section 7(3)* specifies the 2 matters in respect of which the MA must be satisfied before granting approval to an authorized institution to calculate its market risk by using the approach adopted by its parent bank. *Section 8* specifies the action that may be taken by the MA where the MA ceases to be satisfied in respect of those matters in the case of any authorized institution which calculates its market risk by using the approach adopted by its parent bank.

4. *Section 9* prohibits, *inter alia*, an authorized institution which uses the IMA to calculate its market risk in respect of all or any part of its business to use the STM to calculate its market risk in respect of such business unless it has the prior consent of the MA to do so.

5. *Section 10(1)* and *(2)* specifies the market risk positions which an authorized institution must have before the MA will exempt it from *section 3*. The specific effect of an exemption is set out in *section 10(4)(a)* and *(c)*. *Section 11* empowers the MA to revoke an exemption under *section 10* where the market risk positions of the authorized institution concerned fall outside the limits specified in *section 10*.

Part 6 - Standardized approach to calculation of market risk

Division 1 - General

6. *Section 11A* specifies that *Part 6* applies to authorized institutions which use the STM to calculate their market risk, and makes it clear that *Divisions 3, 4, 5* and *6* of *Part 6* do not apply to such institutions' option exposures in debt securities, interest rates, equities, foreign exchange (including gold) and commodities except to the extent specified in *Division 7*, *8* or *9* of *Part 6*. (The calculation of market risk for such option exposures is dealt with in *Divisions 7*, *8* and *9* of *Part 6*). *Section 12* specifies the positions that an authorized institution shall include in the calculation of its market risk. *Section 14* specifies that an authorized institution shall calculate its market risk capital charge by reference to its exposures falling within the various risk categories and by using the fair value of its positions (see the definitions of "fair value", "position" and "risk category" in *section 2(1)*). *Section 15* provides that an authorized institution shall calculate its risk-weighted amount for market risk by multiplying the aggregate of the market risk capital charge (as calculated pursuant to *section 14*) by 12.5.

Divisions 3, _4_, _5_ and _6_ - calculation of market risk capital charge for interest rate exposures (_Division 3_), equity exposures (_Division 4_), foreign exchange exposures (including gold) (_Division 5_) and commodity exposures (_Division 6_)

7. *Divisions 3* to *6* set out the technical requirements with which an authorized institution must comply for the purposes of calculating the market risk capital charge for the 4 kinds of market risk exposures falling within the definition of "risk category" in *section 2(1)*.

Divisions 7, _8_ and _9_ - Calculation of market risk capital charge for option exposures (_Division 7_) using the simplified approach (_Division 8_) or the delta-plus approach (_Division 9_) or another approach that has the prior consent of the MA

8. *Divisions 7*, *8* and *9* set out the technical requirements with which an authorized institution must comply for the purposes of calculating the market risk capital charge for the institution's option exposures in debt securities, interest rates, equities, foreign exchange (including gold) and commodities.

Division 10 - Capital treatment of credit derivative contracts in authorized institution's trading book

9. *Division 10* sets out the technical requirements with which an authorized institution must comply in the capital treatment of its credit derivative contracts in the institution's trading book. *Section 37C* provides that an authorized institution may use credit protection provided by a credit derivative contract in the institution's trading book to offset the market risk capital charge for specific risk calculated for the institution's trading book position in the underlying exposure of the credit derivative contract or in another credit derivative contract. *Sections 37D*, *37E* and *37F* specifies the various degrees or types of offsetting which may be carried out, and the requirements which must be met before that offsetting can be carried out. *Section 37H* specifies, *inter alia*, how an authorized institution shall calculate the amount of capital required to cover the counterparty credit risk arising from a total return swap or credit default swap entered into by the institution (see the definitions of "total return swap" and "credit default swap" in *section 2(1)*). *Section 37I* specifies how an authorized institution shall calculate the amount of capital required to cover the foreign exchange risk arising from a credit derivative contract entered into by the institution which is denominated in a currency other than the Hong Kong dollar.

Part 6A - Internal models approach to calculation of market risk

Division 1 - General

10. *Section 38* specifies that *Part 6A* shall apply to authorized institutions which use the IMA to calculate their market risk. *Section 38A*, similarly to *section 12*, specifies the positions that an authorized institution shall include in the calculation of its market risk. *Section 39(1)* specifies that an authorized institution shall calculate the risk-weighted amount of its market risk exposures as the sum of the market risk capital charge for general market risk calculated by the institution's internal model, and (if applicable) the market risk capital charge for specific risk calculated by the institution's internal model, multiplied by 12.5. *Section 40* provides greater elaboration on how an authorized institution should deal with default risk in respect of its trading book positions. *Section 41(2)* empowers the MA to increase the multiplication factor should an authorized institution which uses the IMA to calculate its market risk cease to fulfil any of the criteria specified in *Schedule 1* applicable to it.

Division 2 - Capital treatment of credit derivative contracts in authorized institution's trading book

11. *Section 49* requires an authorized institution to comply with *Division 1* of *Part 6A* and *Schedule 1* to apply the IMA to calculate its market risk capital charge for credit derivative contracts in its trading book. (An authorized institution which does not use the IMA to calculate its market risk capital charge for such credit derivative contracts must use the STM, as set out in *Division 10* of *Part 6*, to calculate those charges). *Sections 50* and *51* are parallel provisions in *Part 6A* to *sections 37H* and *37I* respectively in *Part 6*.

First draft (Third batch – Asset Securitization)

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SCHEDULE 3 Requirements applicable for securitization transactions that include clean-up calls

SCHEDULE 4 Mapping of ECAI issue specific ratings into credit quality grades/risk-weights applicable under STS

SCHEDULE 5	[Schedule not used]
SCHEDULE 6	[Schedule not used]
SCHEDULE 7	Mapping of ECAI issue specific ratings into credit quality grades/risk-weights applicable under RBM
SCHEDULE 8	[Schedule not used]
SCHEDULE 9	[Schedule not used]
SCHEDULE 10	CCFs for securitizations subject to controlled early amortization provision
SCHEDULE 11	CCFs for securitizations subject to non-controlled early amortization provision

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

In these Rules, unless the context otherwise requires –

"ABCP programme" ( ) means an asset-backed commercial paper programme;

"asset-backed commercial paper programme" ( ) means a programme under which a bankruptcy-remote SPE in a securitization transaction issues debt securities –

(a) with an original maturity of not more than one year; and

(b) the payments in respect of which are secured by a pool of underlying exposures acquired from third parties and held by, or to the order of, that SPE;

"bankruptcy-remote" ( ), in relation to an SPE in a securitization transaction, means that the assets of the SPE will not be available to the creditors of the originator in the transaction in the event that the originator becomes insolvent;

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

"BSA" ( ) means the basic approach;

"capital charge" ( ), in relation to an authorized institution's securitization exposures, means the amount of regulatory capital that the institution is required to hold to cover potential losses arising from the exposures;

"CCF" ( ) means credit conversion factor;

"clean-up call" ( ) -

(a) in relation to a traditional securitization, means an option that permits the originator in the securitization transaction to repurchase the outstanding securitization issues of the securitization transaction once the amount of the outstanding securitization issues, or of the underlying exposures that have not been paid, has fallen below a level specified in the securitization documentation;

(b) in relation to a synthetic securitization, means an option that permits the person providing credit protection under the securitization documentation to extinguish the credit protection once the amount of the reference pool of underlying exposures has fallen below a level specified in the securitization documentation;

"committed" ( ), in relation to a credit line (howsoever described), means the line is not uncommitted;

"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 order to obtain the credit equivalent amount of the exposure;

"credit enhancement" ( ), in relation to a securitization exposure under a securitization transaction, means a contractual arrangement whereby a person –

(a) retains or assumes the credit risk in respect of the securitization exposure; and

(b) provides, in substance, some degree of credit protection to one or more than one other party to the securitization transaction;

"credit-enhancing interest-only strip" ( ), in relation to a securitization transaction, means an on-balance sheet asset –

(a) recorded by the originator in the securitization transaction as representing the expected future excess spread to be derived from the underlying exposures; and

(b) that is subordinated to claims from other parties to the securitization transaction in terms of the priority of repayment;

"credit-enhancing I/O" ( ) means a credit-enhancing interest-only strip;

"credit equivalent amount" ( ), in relation to the calculation of investors' interest under the STS, means the principal amount of the undrawn balances to which investors are exposed, after the deduction of specific provisions applicable to those balances, multiplied by the applicable CCF specified in *Schedule 10* or *11*, as the case requires;

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

"credit protection provider" ( ), in relation to credit protection, means the provider of the collateral or guarantee, or the protection seller under the credit derivative contract, constituting the credit protection;

"dilution risk" ( ), in relation to a receivable purchased by an authorized institution, means the possibility that the amount of the receivable is reduced through cash or non-cash credits to the receivable's obligor;

"drawn balances" ( ), in relation to the calculation of investors' interest, means the amounts of revolving credit lines that have been drawn by the obligors of the credit lines, where -

(a) the credit lines have been sold into a securitization transaction; and

(b) the investors remain, in whole or in part, exposed to future drawings by the obligors under the credit lines available to the obligors;

"EAD" ( ) means exposure at default;

"early amortization period" ( ), in relation to a securitization transaction of which the underlying exposures are revolving in nature, means the period of time within which the originator in the securitization transaction is obliged to fulfil the originator's obligations under an early amortization provision in the securitization documentation once the early amortization provision has been triggered;

"early amortization provision" ( ), in relation to a securitization transaction of which the underlying exposures are revolving in nature, means a mechanism which, once triggered, allows investors in the securitization

transaction to be paid out prior to the originally stated maturity of the securitization issues;

"ECAI" ( ) means external credit assessment institution;

"ECAI issue specific rating" ( ), in relation to a securitization exposure, means a current short-term or long-term credit assessment rating assigned to the exposure by an ECAI;

"EL" ( ) means expected loss;

"excess spread" ( ), in relation to a securitization transaction, means future interest and other income derived by the SPE in the securitization transaction from the underlying exposures of the securitization transaction in excess of the transaction costs specified in the securitization documentation;

"expected loss" ( ), in relation to an exposure of an authorized institution, means the expected loss of the institution on the exposure arising from –

(a) the potential default of the obligor in respect of the exposure; or

(b) the dilution risk relative to the EAD over one year;

"exposure at default" ( ), in relation to an exposure of an authorized institution, means the expected amount of the exposure –

(a) upon the default of the obligor in respect of the exposure; and

(b) measured without deduction of specific provisions and partial write-offs (being, in the case of an off-balance sheet exposure, the credit equivalent amount without such deduction);

"external credit assessment institution" ( ) means –

(a) [Standard and Poor's Corporation;]

(b) [Moody's Investors Services, Inc.; or]

(c) [Fitch Ratings Ltd.;]

"first loss tranche" ( ), in relation to a securitization transaction, means a securitization position that is retained by the originator for providing the first level of financial support to the SPE in the securitization transaction (whether by providing cover against losses incurred by the SPE or by selling assets to the SPE for below their book value or otherwise), under which the support bears, in effect, the risk associated with the underlying exposures held by, or to the order of, the SPE up to a specified or ascertainable level;

"funded credit protection" ( ), in relation to a credit exposure of an authorized institution, means a technique of credit risk mitigation –

(a) whereby the reduction in credit risk of the exposure is derived from the institution's right, in the event of the default of an obligor in respect of the exposure or on the occurrence of other specified credit events relating to the obligor, to liquidate, to receive the transfer of, to appropriate or to retain certain assets or amounts; and

(b) that may involve, for the purposes of *paragraph (a)*, the institution holding collateral against the exposure or issuing a credit-linked note to transfer the credit risk of the exposure to the purchaser of the note;

"gain-on-sale" ( ), in relation to a securitization transaction, means any increase in the core capital of the originating institution resulting from the sale of underlying exposures in the securitization transaction;

"implicit support" ( ), in relation to a securitization transaction, means any direct or indirect support that the originating institution provides (or has provided) to investors in the securitization transaction –

(a) in excess of its predetermined contractual obligations; and

(b) with a view to reducing potential or actual losses that the investors may suffer;

"inferred rating" ( ), in relation to a securitization exposure –

(a) of an authorized institution which uses the RBM; and

(b) which does not have an ECAI issue specific rating,

means a current short-term or long-term credit assessment rating attributed to the exposure by the institution pursuant to *section 16*;

"internal ratings-based approach" ( ), in relation to the calculation of an authorized institution's credit risk for non-securitization exposures, means the method of calculating that risk set out in *Division [..]* of *Part 4*;

"internal ratings-based securitization approach" ( ), in relation to the calculation of an authorized institution's credit risk for securitization exposures, means the method of calculating that risk set out in *Division [ ]* of *Part 7*;

"investing institution" ( ) means an investor which is an authorized institution;

"investment grade" ( ) –

(a) in relation to the use by an authorized institution of the STS to calculate its credit risk for securitization exposures, means a credit quality grade of 3 or better for long-term or short-term ECAI issue specific ratings;

(b) in relation to the use by an authorized institution of the IRBS to calculate its credit risk for securitization exposures, means a credit quality grade of –

(i) 8 or better for long-term ECAI issue specific ratings; and

(ii) 3 or better for short-term ECAI issue specific ratings;

"investor" ( ), in relation to a securitization transaction, means any person, other than the originator, who assumes securitization exposures by -

(a) purchasing securitization issues;

(b) providing credit protection to other parties to the securitization transaction; or

(c) providing liquidity facilities in respect of the transaction;

"investors' interest" ( ), in relation to a securitization transaction of which the underlying exposures are revolving in nature and which has an early amortization provision, means the interest held by investors in the underlying exposures of the securitization transaction;

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

"IRBS" ( ) means the internal ratings-based securitization approach;

"LGD" ( ) means loss given default;

"liquidity facility" ( ), in relation to an authorized institution, means an off-balance sheet securitization exposure of the institution arising from a contractual agreement to provide funding in respect of a securitization transaction to ensure the timeliness of cash flows to an investor;

"long-term ECAI issue specific rating" ( ), in relation to a securitization exposure, means a current long-term credit assessment rating assigned to the exposure by an ECAI;

"long-term inferred rating" ( ), in relation to a securitization exposure, means the exposure has a current long-term credit assessment rating as specified in the definition of "inferred rating";

"look-through treatment" ( ), in relation to a securitization position held by an authorized institution in a securitization transaction, means a method of determining the risk-weight of the position by reference to –

(a) subject to *paragraph (b)*, the risk-weight applicable to the underlying exposures of the securitization transaction;

(b) if the underlying exposures consist of different types of exposure, the weighted average risk-weight applicable to the underlying exposures of the securitization transaction,

using the BSA or STC to calculate the credit risk of the underlying exposures of the securitization transaction;

"loss given default" ( ), in relation to an exposure of an authorized institution, means the loss expected to be incurred by the institution on the

exposure upon the default of the obligor relative to the amount outstanding at default;

"non-securitization exposure" ( ), in relation to an authorized institution, means an exposure of the institution which is not a securitization exposure;

"originating institution" ( ), in relation to a securitization transaction, means the originator is an authorized institution;

"originator" ( ), in relation to a securitization transaction, means a person who –

(a) directly or indirectly originates the underlying exposures included in the securitization transaction; or

(b) serves as a sponsor of an ABCP programme or a programme with similar features;

"potential exposure" ( ), in relation to a securitization exposure arising from an interest rate or exchange rate contract, means the principal amount of the contract multiplied by the applicable CCF;

"principal amount" ( ) means -

(a) in relation to an on-balance sheet securitization exposure of an authorized institution, the current book value of the exposure;

(b) in relation to an off-balance sheet securitization exposure of an authorized institution, the contracted amount of the exposure or, in the case of an exposure which is a partially drawn facility, the amount of the undrawn commitment,

which shall be measured -

(c) after deduction of specific provisions under the use of the STS to calculate the institution's credit risk;

(d) without deduction of specific provisions and partial write-offs under the use of the IRBS to calculate the institution's credit risk.

"rated" ( ), in relation to a securitization exposure, means the exposure has –

(a) an ECAI issue specific rating;

(b) if *paragraph (a)* does not apply, an inferred rating;

"ratings-based method" ( ), in relation to the use of the IRBS to calculate an authorized institution's credit risk for rated securitization exposures, means the method of calculating that risk set out in *Division [..]* of *Part 7*;

"RBM" ( ) means the ratings-based method;

"regulatory capital" ( ), in relation to a securitization exposure of an authorized institution, means the amount of capital the institution is required to hold in respect of the risk-weighted amount of the exposure;

"second loss tranche" ( ), in relation to a securitization transaction, means a securitization position which benefits from the credit enhancement of the first loss tranche;

"securitization exposure" ( ), in relation to an authorized institution, means the institution's exposure to a securitization transaction in its banking book, and includes such an exposure arising from –

(a) the purchase or acquisition of securitization issues for investment purposes;

(b) the provision of credit protection or credit enhancement to any of the parties to the securitization transaction;

(c) the retention of one or more than one securitization position;

(d) the provision of a liquidity facility or similar facility for the securitization transaction;

(e) the repurchase of securitization issues; and

(f) the obligation to acquire any investors' interest in the securitization transaction with an early amortization provision;

"securitization issues" ( ), in relation to a securitization transaction, means the securities issued by the issuer in the securitization transaction;

"securitization position" ( ), in relation to an authorized institution, means an exposure of the institution to one of the different tranches in a securitization transaction;

"securitization transaction" ( ), means a transaction involving the tranching of credit risk associated with a pool of underlying exposures and in respect of which –

(a) there are not less than 2 different tranches;

(b) payments to investors or other parties under the transaction depend on the performance of the underlying exposures; and

(c) the subordination of tranches determines the distribution of losses during the life of the transaction;

"servicer cash advance facility" ( ), in relation to an authorized institution, means an off-balance sheet securitization exposure of the institution arising from a contractual agreement to provide funding in respect of a securitization transaction to ensure an uninterrupted flow of payments to investors in the securitization issues in the securitization transaction;

"SFM" ( ) means the supervisory formula method;

"short-term ECAI issue specific rating" ( ), in relation to a securitization exposure, means a current short-term credit assessment rating assigned to the exposure by an ECAI;

"short-term inferred rating" ( ), in relation to a securitization exposure, means the exposure has a current short-term credit assessment rating as specified in the definition of "inferred rating";

"SPE" ( ) means a special purpose entity;

"special purpose entity" ( ) means a company, trust or other entity –

(a) created for a specific purpose;

(b) the activities of which are limited to those appropriate to accomplish that purpose; and

(c) the structure of which is intended to isolate the company, trust or other entity, as the case may be, from the credit risk of an originator or seller of underlying exposures;

"specific provisions" ( ), in relation to an authorized institution's on-balance sheet or off-balance sheet exposures, mean –

(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;

"sponsor" ( ), in relation to an ABCP programme or a programme with similar features, means a person who establishes the programme and manages, or participates in the management of, the programme by performing one or more than one of the following activities -

(a) approving the sellers to be permitted to participate in the programme;

(b) approving the pool of underlying exposures to be purchased under the programme;

(c) administering the programme, including arranging for the placement into the market of securities issued under the programme; or

(d) providing any credit enhancement or liquidity facility in respect of the programme;

"standardized approach" ( ) –

(a) in relation to the calculation of an authorized institution's credit risk for non-securitization exposures, means the method of calculating that risk set out in *Division [..]* of *Part 4*;

(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 approach for securitization" ( ), in relation to the calculation of an authorized institution's credit risk for securitization exposures, means the method of calculating that risk set out in *Division [..]* of *Part 7*;

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

"STS" ( ) means the standardized approach for securitization;

"supervisory formula" ( ) means *Formula 2* set out in *section 17*;

"supervisory formula method" ( ), in relation to the use of the IRBS to calculate an authorized institution's credit risk for securitization exposures which are unrated, means the method of calculating that risk set out in *Division 7* of *Part 7*;

"synthetic securitization" ( ) means a securitization transaction where the credit risk of a pool of underlying exposures is transferred, in whole or in part, through the use of funded or unfunded credit protection that serves to hedge the credit risk of the underlying exposures which remain on the balance sheet of the originator;

"traditional securitization" ( ) means a securitization transaction where –

(a) a pool of underlying exposures is sold by the originator to a bankruptcy-remote SPE; and

(b) the cash flows from the pool of underlying exposures are used to service payments to investors or other parties under the transaction.

"tranche" ( ) means a contractually established segment ("relevant segment") of the credit risk associated with a pool of underlying exposures in a securitization transaction where –

(a) a position in the relevant segment entails a risk of credit loss greater than, or less than, that of a position of the same amount in each other contractually established segment; and

(b) no account is taken of credit protection provided by third parties directly to the holders of positions in the relevant segment or in other contractually established segments;

"uncommitted" ( ), in relation to a credit line extended by an authorized institution to an obligor, means the line is unconditionally cancellable by the institution without prior notice to the obligor;

"underlying exposures" ( ), in relation to a securitization transaction, means one or more than one on-balance sheet or off-balance sheet exposure in respect of which the credit risk is transferred to one or more than one person by the originator in the securitization transaction;

"undrawn balances" ( ), in relation to the calculation of investors' interest, mean the amounts of revolving credit lines that have not been drawn by the obligors of the credit lines, where –

(a) the credit lines have been sold into a securitization transaction; and

(b) the investors remain, in whole or in part, exposed to future drawings by the obligors under the credit lines available to the obligors;

"unfunded credit protection" ( ), in relation to a credit exposure of an authorized institution, means a technique of credit risk mitigation where the reduction in credit risk of the exposure is derived from the institution realizing the undertaking of a third party (including that under a guarantee or a credit default swap) to pay an amount in the event of –

(a) the default of an obligor in respect of the exposure; or

(b) the occurrence of another specified credit event relating to that obligor;

"unrated" ( ), in relation to a securitization exposure, means the exposure is not a rated exposure;

"weighted average risk-weight" ( ), in relation to a securitization transaction where the underlying exposures consist of different types of exposure, means the average risk-weight of the pool of exposures derived by taking the risk-weight of each type of exposure weighted to reflect the proportion of the principal amount of the type of exposure concerned to the aggregate principal amount of the exposures in the pool.

(2) For the avoidance of doubt, it is hereby declared that no reference in these Rules to a securitization transaction shall be construed as excluding a reference to a securitization transaction which has more than one originating institution or more than one SPE.

PART 2

APPLICATION OF THESE RULES

3. Calculation of credit risk for securitization exposures

(1) Subject to *subsections (2)* and *(3)* and *section 4*, an authorized institution shall –

(a) only use the STS to calculate its credit risk for securitization exposures in a securitization transaction if –

(i) it uses the STC to calculate its credit risk for the type of exposures that is the same as the type of underlying exposures; or

(ii) it uses the BSA to calculate its credit risk for the type of exposures that is the same as the type of underlying exposures;

(b) only use the IRBS to calculate its credit risk for securitization exposures in a securitization transaction if it uses the IRB to calculate its credit risk for the type of exposures that is the same as the type of underlying exposures.

(2) Where a securitization transaction has –

(a) 2 or more types of underlying exposures; and

(b) an authorized institution which holds a securitization exposure in respect of the securitization transaction uses any combination of the STC, IRB or BSA to calculate its credit risk for those types,

then the institution shall, after consultation with the Monetary Authority and unless otherwise directed by the Monetary Authority -

(c) use the STS to calculate its credit risk for the securitization exposure if the STC or BSA is used to calculate its credit risk for the majority of those types;

(d) use the IRBS to calculate its credit risk for the securitization exposure if the IRB is used to calculate its credit risk for the majority of those types.

(3) Where an authorized institution holds a securitization exposure in a securitization transaction and uses the IRB to calculate its credit risk; and –

(a) [provision not used]

(b) the IRB has no specific treatment for exposures of the same type as the type of underlying exposures in the securitization transaction; or

(c) the institution does not have the prior consent of the Monetary Authority to use the IRB to calculate its credit risk for the type of exposures that is the same as the type of underlying exposures in the securitization transaction,

then the institution shall use the STS to calculate its credit risk for the securitization exposures in the securitization transaction.

(4) For the purposes of *subsection (2)*, an authorized institution shall determine which is the majority of the types of underlying exposures referred to in that subsection by reference to, for each type of underlying exposures, the principal amount of

on-balance sheet exposures and the credit equivalent amount of off-balance sheet exposures under the use of the STC by the institution, or the EAD of off-balance sheet exposures under the use of the IRB by the institution, as the case requires.

4. Use of RBM or SFM to calculate credit risk for securitization exposures under IRBS

An authorized institution which uses the IRBS to calculate its credit risk for securitization exposures –

(a) shall use the RBM to calculate the risk-weighted amount of its rated securitization exposures;

(b) subject to *paragraph (c)*, shall, with the prior consent of the Monetary Authority, use the SFM to calculate the capital charge for its unrated securitization exposures;

(c) subject to *paragraph (d)*, shall deduct from its capital base any unrated securitization exposure of the institution in respect of which the SFM cannot be used to calculate the institution's credit risk for the exposure because the institution lacks the consent referred to in *paragraph (b)* or because of any other reason;

(d) may, with the prior consent of the Monetary Authority, apply the method specified in *section 25(3)* on an exceptional or temporary basis to calculate the risk-weighted amount of unrated eligible liquidity facilities extended by the institution.

PART 7

SECURITIZATION

Division 1 – General

5. Treatment to be accorded securitization transaction by originating institution

(1) Subject to *subsection (2)*, an originating institution in a securitization transaction may, with the prior consent of the Monetary Authority –

(a) in the case of a traditional securitization where all the requirements of *Schedule 1* applicable to or in relation to the institution and the securitization transaction have been fulfilled, exclude the underlying exposures from the calculation of its credit risk;

(b) in the case of a synthetic securitization where all the requirements of *Schedule 2* applicable to or in relation to the institution and the securitization transaction have been fulfilled, calculate the risk-weighted amount of the underlying exposures in accordance with *Division 10.*

(2) Notwithstanding that a securitization transaction falls within *subsection (1)*, the originating institution shall hold [regulatory capital] against any securitization exposure that it retains, holds or purchases under the securitization transaction.

(3) Subject to *subsection (4)*, the originating institution in a traditional securitization that does not fall within *subsection (1)(a)* shall risk-weight the underlying

exposures in accordance with that approach to the calculation of its credit risk that it uses for the type of exposures that is the same as the type of the underlying exposures.

(4) Notwithstanding that a traditional securitization does not fall within *subsection (1)(a)*, the originating institution of the securitization transaction shall not include in its capital base any gain-on-sale arising from the transaction.

(5) The originating institution in a synthetic securitization that does not fall within *subsection (1)(b)* shall risk-weight the underlying exposures -

(a) by not taking into account the effect of any credit risk mitigation in respect of the underlying exposures; and

(b) in accordance with that approach to the calculation of its credit risk that it uses for the type of exposures that is the same as the type of the underlying exposures.

[**5A. Provision not used.]**

6. Action that may be taken by Monetary Authority if originating institution provides implicit support

(1) The originating institution in a securitization transaction falling within *section 5(1)* shall not provide implicit support to investors in the securitization transaction.

(2) Where the originating institution in a securitization transaction provides implicit support in contravention of *subsection (1)*, then the Monetary Authority may, after having had regard to the materiality of the contravention –

(a) require the institution to not use (or, where applicable, withdraw any consent of the Monetary Authority for the institution to use) *section 5(1)(a)* or *(b)*, or *section 5(1)(a)* and *(b)* -

(i) for that securitization transaction; or

(ii) for other securitization transactions in respect of which the institution is the originating institution and for such period, or until the occurrence of such event, as is specified by the Monetary Authority in the requirement;

(b) require the institution to publicly disclose particulars of the implicit support and its impact on the institution's regulatory capital; or

(c) advise the institution that the Monetary Authority is considering exercising the power under section 101 of the Ordinance to vary the capital adequacy ratio of the institution by increasing it.

(3) The originating institution in a securitization transaction shall comply with a requirement given to it under *subsection (2)(a)* or *(b)*.

(4) Where -

(a) a securitization transaction contains a clean-up call; and

(b) the clean-up call can be exercised by the originating institution in such a way that it thereby provides credit enhancement,

then the clean-up call shall be treated as implicit support and the provisions of these Rules relating to implicit support shall apply accordingly.

Division 2 **– Calculation of regulatory capital for securitization exposures**

7. Calculation of risk-weighted amount

(1) Subject to *subsections (2)* to *(6)*, an authorized institution shall calculate the risk-weighted amount of a securitization exposure held by it by applying the relevant risk-weight to the principal amount of the exposure by reference to its ECAI issue-specific rating or otherwise in accordance with these Rules.

(2) Subject to *subsections (4)* and *(5)*, an authorized institution shall calculate the risk-weighted amount of an on-balance sheet securitization exposure –

(a) if the institution uses the STS or the RBM to calculate its credit risk for that exposure, by multiplying the principal amount of the exposure by the applicable risk-weight;

(b) if the institution uses the SFM to calculate its credit risk for that exposure, by multiplying the amount of capital charge calculated in respect of the exposure by 12.5.

(3) Subject to *subsections (4)* and *(5)*, an authorized institution shall calculate the risk-weighted amount of an off-balance sheet securitization exposure –

(a) if the institution uses the STS or RBM to calculate its credit risk for that exposure, by –

(i) converting the exposure into a credit equivalent amount by multiplying the principal amount of the exposure by the applicable CCF; and

(ii) multiplying that credit equivalent amount by the applicable risk-weight;

(b) if the institution uses the SFM to calculate its credit risk for that exposure, by –

(i) multiplying the capital charge calculated in respect of the exposure by 12.5; and

(ii) multiplying the risk-weighted amount obtained under *subparagraph (i)* by the applicable CCF;

(c) unless otherwise specified in *Division 5*, *6*, *8* or *9*, by applying a CCF of 100% to the exposure.

(4) Where a securitization exposure held by an authorized institution is subject to funded or unfunded credit protection, the institution shall adjust the regulatory capital for the exposure in accordance with *Division 11*.

(4A) If an authorized institution other than the originating institution in a securitization transaction provides credit protection to a securitization issue, the institution providing the credit protection shall calculate its regulatory capital in respect of the credit protection as if it were an investor in the securitization issue.

(4B) If an authorized institution other than the originating institution in a securitization transaction provides credit protection to an unrated credit enhancement, the institution providing the credit protection shall calculate its regulatory capital in respect of the credit protection as if it directly provided the unrated enhancement.

(5) Where an authorized institution provides 2 or more overlapping facilities in respect of a securitization transaction, the institution shall, to the extent that the

facilities overlap, include in its risk-weighted amount only the facility, or the part of the facility, that produces the higher risk-weighted amount, in accordance with *section 27*.

(6) An authorized institution shall use the aggregate risk-weighted amount of its securitization exposures calculated under the IRBS for the purpose of calculating its capital adequacy ratio only after multiplying that amount by a scaling factor specified by the Monetary Authority in *section [..]* of *Part 4*.

Division 3 – External credit assessments

8. Use of external credit assessments for determination of risk-weights

Subject to *section 9*, *sections [..]* of *Part 4* relating to ECAI ratings shall, for the purposes of this Part and with all necessary modifications, apply to and in relation to securitization exposures.

9. Provision applicable to ECAI ratings in addition to those applicable under [*Part 4*]

(1) An authorized institution which uses the STS or RBM to calculate the risk-weighted amount of its rated securitization exposures –

[(a) provision not used;]

(b) subject to *paragraphs (c)* and *(d)*, shall use ECAI issue specific ratings issued by the same ECAIs consistently for a given type of securitization exposure;

(c) shall not use ECAI issue specific ratings issued by an ECAI for one or more than one securitization position and the ECAI issue specific ratings issued by another ECAI for other securitization positions (whether retained or purchased) that may or may not be rated by the first-mentioned ECAI in respect of the same securitization transaction;

(d) shall apply *section [..]* where 2 or more ECAIs which may be used have different ECAI issue specific ratings applicable to the same securitization exposure in respect of the same securitization transaction;

(e) if under a securitization transaction credit protection is -

(i) provided directly to the SPE by a credit protection provider falling within *section [..]*; and

(ii) reflected in the ECAI issue specific rating assigned to a securitization exposure,

then the institution –

(iii) shall use the risk-weight determined by reference to that rating; and

(iv) shall not otherwise recognize, for the purposes of this Part, that credit protection;

(f) if under a securitization transaction credit protection is provided directly to the SPE by a credit protection provider not falling within *section [..]*, then the institution shall treat the securitization exposure covered by the credit protection as unrated;

(g) if under a securitization transaction credit protection is not obtained by the SPE but is applied to a specific rated securitization exposure held by the institution (whether a tranche of asset-backed securities or otherwise), then the institution shall –

(i) treat the exposure as if it were unrated; and

(ii) use the credit risk mitigation treatment –

(A) specified in *Part [..]*; or

(B) specified in *Part [..]*,

to recognize the effect of the credit protection that applies to that exposure.

Division 4 - Deductions from capital base

10. Deductions from capital base

(1) Subject to *subsection (2)*, an authorized institution shall deduct from it capital base -

(a) any credit-enhancing I/O recorded by the institution as the originating institution in a securitization transaction (after deduction of any gain-on-sale arising from the credit-enhancing I/O);

(b) any gain-on-sale arising from a securitization transaction where the institution is the originating institution; or

(c) if the institution uses the STS to calculate its credit risk for securitization exposures, any rated securitization exposure of the institution with -

(i) a long-term credit quality grade of 4 or higher in the case of a securitization exposure held by the institution as the originating institution;

(ii) a long-term credit quality grade of 5 in the case of a securitization exposure held by the institution as an investing institution;

(iii) a short-term credit quality grade of 4,

as allocated under Table A or Table B, as the case may be, of *Schedule 4*;

(d) if the institution uses the STS to calculate its credit risk for securitization exposures, any unrated securitization exposure of the institution except where the securitization exposure is -

(i) the most senior tranche in a securitization transaction that falls within *section 13(1)*;

(ii) a second loss tranche or better in an ABCP programme that falls within *section 14*; or

(iii) a liquidity facility that falls within *section 23*;

(e) if the institution uses the RBM [under the IRBS] to calculate its credit risk for securitization exposures, any rated securitization exposure of the institution with a long-term credit quality grade of 12 or a short-term credit quality grade of 4 as allocated, respectively, under Table A or Table B of *Schedule 7*;

(f) if the institution uses the SFM [under the IRBS] to calculate its credit risk for securitization exposures, any unrated securitization exposure of the institution with a risk-weight of not less than 1250%;

(g) if the institution uses the IRBS to calculate its credit risk for securitization exposures but cannot use the SFM, or the method specified in *section 25(3)* for liquidity or servicer cash advance facilities, because it lacks the Monetary Authority's consent to do so or because of any other reason, any unrated securitization exposure of the institution; and

(h) any other securitization exposure specified by the Monetary Authority in a notice in writing [given to the institution].

(2) An authorized institution required by *subsection (1)* to make a deduction from its capital base shall make the deduction -

(a) based on -

(i) the principal amount of the deductible item if the institution uses the STS to calculate its credit risk for securitization exposures; or

(ii) the principal amount of the deductible item (after deduction of any specific provision, partial write-off or non-refundable purchase price discount, as the case may be, made against the deductible item) if the institution uses the IRBS to calculate its credit risk for securitization exposures;

(b) subject to *section 23A(1)* of *Part 3* and *paragraph (c)*, 50% from its core capital and 50% from its supplementary capital;

(c) in the case of a deduction falling within *subsection (1)(b)*, 100% from its core capital.

Division 5 – Maximum capital requirement for originating institution

11. General

Notwithstanding any other provision of this Division but subject to *section 30*, the regulatory capital required to be held by the originating institution in a securitization transaction in respect of the securitization exposures retained by it shall not exceed the regulatory capital it would have been required to hold in respect of the underlying exposures if the underlying exposures had not been securitized.

Division 5A – Risk–weighting requirements under STS

12. Determination of risk-weights under STS

An authorized institution which uses the STS to calculate its credit risk for securitization exposures shall –

(a) for the purposes of deriving the risk-weights to be used under the STS, map ECAI issue specific ratings to a scale of uniform credit quality grades represented –

(i) by the numerals 1, 2, 3, 4 and 5 for long-term ECAI issue specific ratings as specified in Table A set out in *Schedule 4*; and

(ii) by the numerals 1, 2, 3 and 4 for short-term ECAI issue specific ratings as specified in Table B set out in *Schedule 4*;

(b) allocate risk-weights –

(i) in accordance with Table A set out in *Schedule 4* in the case of long-term ECAI issue specific ratings; and

(ii) in accordance with Table B set out in *Schedule 4* in the case of short-term ECAI issue specific ratings;

(c) in the case of a securitization exposure of the institution which has a long-term ECAI issue specific rating which maps to a credit quality grade of 4 –

(i) risk-weight the exposure at 350% if the institution is an investing institution;

(ii) deduct the exposure from the institution's capital base if the institution is the originating institution;

(d) treat all securitization exposures of the institution not falling within *paragraph (c)* the same whether the institution is the originating institution or an investing institution.

12A. Exceptions to deduction for unrated securitization exposures

An authorized institution which uses the STS to calculate its credit risk for securitization exposures shall deduct from its capital base all of its unrated securitization exposures except any such exposure falling within *section 13(1)*, *14* or *23*.

13. Most senior tranche in securitization transaction

(1) Where an authorized institution –

(a) holds a securitization position in the most senior tranche in a securitization transaction and the tranche is unrated; and

(b) knows the current composition of the pool of underlying exposures,

then the institution shall determine the risk-weight to be allocated to the position by applying the look-through treatment.

[(2) Provision not used.]

[(3) Provision not used.]

[(4) Provision not used.]

(5) Where an authorized institution is determining whether a tranche is the most senior tranche in a securitization transaction, the institution shall disregard –

(a) any interest rate or exchange rate contract entered into for the purpose of hedging the respective interest rate risk or foreign exchange risk in the securitization transaction; and

(b) fees or other similar payments due under the securitization transaction.

(6) Where an authorized institution is unable to determine in accordance with this section the risk-weights to be allocated to the underlying exposures referred to in *subsection (1)* because it lacks the knowledge referred to in *paragraph (b)* of that subsection, then it shall deduct the securitization position referred to in that subsection from its capital base.

14. Securitization positions that are in second loss tranche or better in ABCP programmes

[Subject to *section [..]*,] where –

(a) an authorized institution holds an unrated securitization position in an ABCP programme;

(b) the position is [in a tranche which is economically] in a second loss tranche or better in the securitization transaction and the first loss tranche provides credit enhancement to the second loss tranche;

[(c) the credit risk of the position is [the equivalent of] investment grade; and]

(d) the institution does not also hold a securitization position in the first loss tranche,

then the institution shall allocate a risk-weight of the greater of –

(e) 100%; or

(f) the highest risk-weight which would be allocated, under the approach used by the institution to calculate its credit risk for the type of underlying exposures, to any of the underlying exposures covered by the position.

Division 6 – Risk-weighting requirements under RBM

15. Determination of risk-weights under RBM

(1) An authorized institution which uses the RBM to calculate its credit risk for rated securitization exposures shall –

(a) for the purposes of deriving the risk-weights to be used under the RBM, map ECAI issue specific ratings to a scale of uniform credit quality grades represented –

(i) by the numerals 1 to 12 for long-term ECAI issue specific ratings as specified in Table A set out in *Schedule 7*;

(ii) by the numerals 1, 2, 3 and 4 for short-term ECAI issue specific ratings as specified in Table B set out in *Schedule 7*;

(b) allocate risk-weights –

(i) in accordance with Table A set out in *Schedule 7* in the case of long-term ECAI issue specific ratings; and

(ii) in accordance with Table B set out in *Schedule 7* in the case of short-term ECAI issue specific ratings.

(2) *Subsection (1)* shall apply to and in relation to an inferred rating as it applies to an ECAI issue specific rating.

(3) An authorized institution which uses the RBM to calculate credit risk for its securitization exposures shall treat a securitization position in a tranche as a senior

position if the tranche is effectively backed or secured by a first legal claim on the entire amount outstanding in respect of the underlying exposures.

(4) For the purposes of determining whether a securitization position in a tranche falls within *subsection (3)*, an authorized institution shall not take account of –

(a) any interest rate or exchange rate contract entered into for the purpose of hedging the respective interest rate risk or foreign exchange risk in the securitization transaction; and

(b) fees or other similar payments due under the securitization transaction.

(5) An authorized institution shall allocate the risk-weights specified in Table A set out in *Schedule 7* to its securitization exposures if the exposures have –

(a) a long-term ECAI issue specific rating; or

(b) a long-term inferred rating.

(6) An authorized institution shall, in the case of a securitization exposure referred to in *subsection (5)*, allocate –

(a) the risk-weights specified in *column A* of Table A set out in *Schedule 7* if –

(i) the effective number of underlying exposures specified in *subsection (7)* is not less than 6; and

(ii) the position falls within *subsection (3)*;

(b) the risk-weights specified in *column C* of Table A set out in *Schedule 7* if the effective number of underlying exposures specified in *subsection (7)* is less than 6.

(7) For the purposes of *subsection (6)*, an authorized institution shall calculate the effective number of underlying exposures by –

(a) treating multiple exposures to one obligor as one exposure; and

(b) subject to *subsection (8)*, the use of *Formula 1*.

Formula 1

Calculation of N

$$N = \frac{\left(\sum_i EAD_i\right)^2}{\sum_i EAD_i^2}$$

where:

N = effective number of underlying exposures (in the case of a re-securitization as specified in *subsection (8)*, the effective number of securitization exposures which have been securitized)**;**

EAD_i = the exposure at default associated with the ith obligor in the pool of underlying exposures.

(8) Where there is a further securitization of securitization exposures ("relevant exposures") of an authorized institution ("re-securitization"), the institution –

(a) shall take into account the number of relevant exposures in the pool for the re-securitization instead of the number of underlying exposures in the original pools in the securitization transactions creating the relevant exposures; and

(b) may, for the purposes of *Formula 1*, if the portfolio share (being the amount of the largest exposure in the pool as a percentage of

the total amount of the pool of the relevant exposures) of the largest exposure ("C_1") is available, compute *N* in that formula as $1/C_1$.

(9) An authorized institution shall allocate the risk-weights specified in *column B* of Table A set out in *Schedule 7* to all of its securitization exposures which do not fall within *subsection (6)(a)* or *(b)*.

(10) Subject to *subsection (11)*, an authorized institution shall allocate the risk-weights specified in Table B set out in *Schedule 7* to its securitization exposures if the exposures have –

(a) a short-term ECAI issue specific rating;

or

(b) a short-term inferred rating.

(11) *Subsections (6), (7), (8)* and *(9)* shall, with all necessary modifications, apply to and in relation to any rating referred to in *subsection (10)* and to Table B set out in *Schedule 7* as they apply to and in relation to any rating referred to in *subsection (5)* and to Table A set out in that Schedule.

16. Use of inferred ratings

An authorized institution shall only attribute an inferred rating to a securitization exposure held by it if –

(aa) the exposure has no applicable ECAI issue specific rating;

(a) the reference securitization exposure (being an externally rated securitization exposure) is subordinate in all respects to the exposure after taking into account credit enhancements, if any, when assessing the relative subordination of the exposure and the reference securitization exposure;

(b) the maturity of the reference securitization exposure is not less than that of the exposure;

(c) the inferred rating is updated from time to time in order to reflect any changes in the ECAI issue specific rating of the reference securitization exposure; and

(d) the ECAI issue specific rating of the reference securitization exposure fulfils the requirements for recognition of ECAI issue specific ratings as specified in *sections 8* and *9*.

Division 7 – Risk-weighting requirements under SFM

[17A.] Application] - not used.

17. Use of supervisory formula

(1) An authorized institution shall allocate that risk-weight for each of its unrated securitization exposures that is the greater of –

(a) 7%; or

(b) the risk-weight determined under this Division for the exposure.

(2) Subject to *subsections (3), (4)* and *(6)*, an authorized institution shall, for the purposes of using the supervisory formula to calculate the capital charge for any securitization position in a given tranche of a securitization transaction, determine –

(a) the capital charge that the underlying exposures would have attracted under the use of the IRB for the calculation of credit risk if the underlying exposures had not been securitized ("K_{IRB}");

(b) subject to *section 18*, the tranche's credit enhancement level (*L*);

(c) subject to *section 19*, the tranche's thickness (*T*);

(d) subject to *sections 20* and *22*, the pool's effective number of underlying exposures (*N*); and

(e) subject to *sections 21* and *22*, the pool's exposure-weighted average *LGD*.

(3) Subject to *subsection (4)*, an authorized institution shall calculate the capital charge for any securitization position in a tranche of a securitization transaction by multiplying –

(a) the amount of underlying exposures; by

(b) the greater of 0.0056**T* or (*S[L+T] – S[L]*),

where:

function *S [.]* = the supervisory formula.

(4) Where an authorized institution holds only a proportional interest in a securitization position in a tranche, the institution shall calculate the capital charge for its interest in the position as equal to its prorated share of the capital charge calculated for the entire tranche.

[(5) Provision not used.]

Formula 2

Supervisory formula

$$S[L] = \begin{cases} L & when\ L \le K_{IRB} \\ K_{IRB} + K[L] - K[K_{IRB}] + (d \cdot K_{IRB} / \omega)(1 - e^{\omega(K_{IRB} - L)/K_{IRB}}) & when\ K_{IRB} < L \end{cases}$$

where:

$$h = (1 - K_{IRB} / LGD)^{N}$$

$$c = K_{IRB} / (1 - h)$$

$$v = \frac{(LGD - K_{IRB})\, K_{IRB} + 0.25\,(1 - LGD)\, K_{IRB}}{N}$$

$$f = \left(\frac{v + K_{IRB}^{2}}{1 - h} - c^{2} \right) + \frac{(1 - K_{IRB})\, K_{IRB} - v}{(1 - h)\, \tau}$$

$$g = \frac{(1 - c)\, c}{f} - 1$$

$$a = g \cdot c$$

$$b = g \cdot (1 - c)$$

$$d = 1 - (1 - h) \cdot (1 - Beta\,[K_{IRB}\,;\, a\,,\, b])$$

$$K[L] = (1 - h) \cdot ((1 - Beta\,[L\,;\, a\,,\, b])\, L + Beta\,[L\,;\, a + 1\,,\, b]\, c)$$

$\tau = 1000$

$\omega = 20$

(6) For the purposes of the supervisory formula –

(a) Beta [L; α, b] is the cumulative beta distribution with parameters α and b evaluated at L;

(b) K_{IRB} is the ratio, expressed in decimal form, of –

(i) the IRB capital charge (including the EL portion) for the pool of underlying exposures –

(A) as if those exposures were held directly by the authorized institution concerned; and

(B) subject to the effect of any credit protection covering or benefiting those exposures, whether individually or to the entire pool,

to -

(ii) the sum of drawn amounts in respect of the underlying exposures plus the EAD associated with undrawn commitments in respect of the underlying exposures;

(c) if there is an SPE in a securitization transaction, all the assets of the SPE that are related to the securitization transaction shall be treated as underlying exposures in the pool (including assets in the form of a reserve account, whether a cash collateral account or otherwise);

(d) if any resulting risk-weight (that is, (capital charge* 12.5)/T) for a securitization exposure is 1250% or above, then the authorized

institution concerned shall deduct the securitization exposure subject to that risk-weight in accordance with *section 10(1)(d)(ii)*;

(e) in any case where an authorized institution has set aside a specific provision, or made a partial write-off, in respect of, or has a non-refundable purchase price discount on, an underlying exposure in the pool –

(i) the amounts referred to in *paragraph (b)* shall be calculated using the gross amount of the underlying exposure without deducting the specific provision, partial write-off or the non-refundable purchase price discount, as the case may be;

(ii) if the underlying exposure is in default, the amount of the specific provision, partial write-off or non-refundable purchase price discount, as the case may be, may be used to reduce the amount of any deduction from the institution's capital base required to be made in respect of that exposure.

18. Credit enhancement level of tranche (*L*)

For the purposes of the supervisory formula –

(a) *L* is the ratio, expressed in decimal form, of –

(i) the principal amount of all securitization positions subordinate to the tranche concerned,

to -

(ii) the sum of drawn amounts in respect of the underlying exposures plus the EAD associated with undrawn commitments in respect of the underlying exposures;

(b) the authorized institution shall –

(i) determine *L* before considering the effects of any tranche-specific credit enhancement (including third party guarantees that benefit only a single tranche); and

(ii) exclude from the measurement of *L* any gain-on-sale or credit enhancing I/Os realized or held by the institution in respect of the securitization transaction concerned;

(c) subject to *paragraph (d)*, if any interest rate or exchange rate contract, entered into by an authorized institution with another person for the purpose of hedging any interest rate or foreign exchange risk, as the case may be, arising from the securitization position held by the institution, ranks junior for payment to the tranche concerned, then the institution may measure the principal

amount of the contract at its current exposure (without taking into account that contract's potential exposure) in calculating *L*;

(d) if the current exposure of an interest rate or exchange rate contract cannot be measured, then the authorized institution concerned shall disregard that contract in the calculation of *L*;

(e) an authorized institution may include in the calculation of *L* any reserve account funded by accumulated cash flows from the underlying exposures that is junior to the tranche concerned; and

(f) an authorized institution shall not include in the calculation of *L* any unfunded reserve accounts that are to be funded from future receipts from the underlying exposures.

19. Thickness of tranche (*T*)

For the purposes of the supervisory formula –

(a) *T* is measured as the ratio of –

(i) the principal amount of the tranche concerned;

to -

(ii) the sum of drawn amounts in respect of the underlying exposures plus the EAD associated with undrawn commitments in respect of the underlying exposures; and

(b) in determining the principal amount of an authorized institution's securitization exposure arising from an interest rate or exchange rate contract entered into by the institution with another person for the purpose of hedging any interest rate or foreign exchange risk, the institution shall –

(i) take into account the potential exposure of the securitization exposure; and

(ii) if the current exposure of the securitization exposure –

(A) is not negative, measure the securitization exposure by aggregating the current exposure and the potential exposure;

(B) is negative, measure the securitization exposure by using only the potential exposure.

20. Effective number of underlying exposures (*N*)

For the purposes of the supervisory formula, the authorized institution shall –

(a) use *Formula 1* to calculate the effective number of underlying exposures;

(b) treat multiple exposures to one obligor as one exposure; and

(c) if the securitization is a re-securitization, use *Formula 1* in accordance with *section 15(8)*.

21. Exposure-weighted average *LGD*

For the purposes of the supervisory formula –

(a) the authorized institution shall use *Formula 3* to calculate the exposure-weighted average *LGD*;

(b) if the securitization is a re-securitization, the authorized institution shall apply an *LGD* of 100% to the relevant exposures in the pool for the re-securitization;

(c) subject to *paragraph (d)*, if the underlying exposures of a securitization transaction are purchased receivables and the default risk and dilution risk for the purchased receivables are treated by the institution in an aggregate manner (whether by means of the institution holding a single reserve or over-collateralization being available to the institution to cover losses from either default or dilution risk or by other means), the institution shall, for the purposes of the *LGD* to be used in *Formula 3* for calculating the exposure-weighted average *LGD*, first determine the *LGD* [as] a weighted average of the *LGD* for default risk and a 100% *LGD* for dilution risk;

(d) the authorized institution shall determine the respective weights of default risk and dilution risk referred to in *paragraph (c)* by reference to the proportion that the capital charge calculated for that default risk and the capital charge calculated for that dilution risk respectively bear to the aggregate capital charge calculated for

default risk and dilution risk under the use of the IRB to calculate credit risk in respect of the underlying exposures.

Formula 3

Calculation of exposure-weighted average LGD

$$LGD = \frac{\sum_i LGD_i \cdot EAD_i}{\sum_i EAD_i}$$

where:

LGD_i = the average *LGD* associated with i^th obligor in the pool of underlying exposures; and

EAD_i = the exposure of default associated with the ith obligor in the pool of underlying exposures.

22. Simplified method for calculating *N* and *LGD*

For the purposes of the supervisory formula –

(a) if the amount outstanding under the largest exposure, C_I, in the pool of underlying exposures is no more than 0.03 or 3% of the aggregate amount of all the underlying exposures in the pool, then the authorized institution may set *LGD* at 0.50 and, if so, *N* is calculated by the use of *Formula 4*;

Formula 4

Simplified method for computing N

$$N = \left(C_1 C_m + \left(\frac{C_m - C_1}{m - 1} \right) \max \{1 - m C_1 , 0\} \right)^{-1}$$

where:

[C_m = the share of the pool of underlying exposures corresponding to the sum of the largest "*m*" exposures (for example, a 15% share corresponds to a value of 0.15) and the level of "*m*" is set by the authorized institution making the regulatory capital calculation];

(b) if only C_I is known to the authorized institution and this amount is no more than 0.03, the institution may set *LGD* at 0.50 and $N = 1/C_I$; and

(c) if the underlying exposures are retail exposures, then the authorized institution may use a value for *h* of zero and a value for *v* of zero.]

Division 8 – Treatment of liquidity/servicer cash advance facilities

23. Eligible liquidity facilities

A liquidity facility provided by an authorized institution, which forms part of a securitization transaction, is an eligible liquidity facility [for the purposes of […] where –

(a) subject to *paragraph (b),* the facility documentation clearly identifies and limits the circumstances under which the facility may be drawn;

(b) drawings under the facility are limited to the amount that is likely to be repaid fully from the liquidation of the underlying exposures and any credit enhancements provided by the originator of the underlying exposures;

(c) the facility is not able to be drawn so as to provide credit support to cover losses already incurred in respect of the pool of underlying exposures prior to the drawing;

(d) the facility is neither –

(i) used to provide permanent or regular funding to investors in the securitization issues; nor

(ii) structured such that drawdown is certain,

as indicated by regular or continuous drawings;

(e) the facility is subject to an asset quality test that precludes it from being drawn to cover underlying exposures that are in default as

defined in the IRB, regardless of whether the STS or IRBS is used to calculate credit risk for securitization exposures;

(f) if the securitization issues supported by the facility are rated, the facility can only be drawn to make payment in respect of those securitization issues that are rated as investment grade at the time of drawdown;

(g) the facility is not capable of being drawn after all applicable (whether securitization transaction-specific or programme-wide) credit enhancements from which the facility would benefit have been exhausted; and

(h) repayment of drawings on the facility is not subordinated to the claims of investors in the securitization issues or subject to deferral or waiver by the authorized institution that extends the facility.

24. Liquidity facilities under STS

(1) Subject to *subsection (2)*, an authorized institution which uses the STS to calculate its credit risk for securitization exposures shall -

(a) in the case of a liquidity facility provided by it which is rated (whether or not it is an eligible liquidity facility) –

(i) apply *Schedule 4* to the facility; and

(ii) apply a CCF of 100% to the facility;

(b) in the case of an eligible liquidity facility provided by it which is unrated –

(i) apply to the facility the highest risk-weight that would be applied to any of the underlying exposures covered by the facility as determined pursuant to the approach used by the institution to calculate its credit risk for the type of underlying exposures; and

(ii) apply a CCF to the facility of –

(A) 20% if the facility has an original maturity of not more than one year;

(B) 50% if the facility has an original maturity of more than one year.

(2) Where an eligible liquidity facility provided by an authorized institution –

(a) is only available in the event of a general market disruption such that more than one SPE in different securitization transactions are unable to roll over maturing commercial paper and that inability is

not the result of an impairment in the credit quality of the SPE in the securitization transaction to which the liquidity facility relates or in the credit quality of the underlying exposures; and

(b) only advances funds to pay investors in the securitization issues concerned that –

(i) are secured by the underlying exposures; and

(ii) rank not less than pari passu with the claims of those investors,

then the institution may apply a CCF of 0% to the facility.

(3) Where a liquidity facility provided by an authorized institution does not fall within *subsection (1)(a)* or *(b)* or *(2)*, the institution shall –

(a) apply a CCF of 100% to the facility; and

(b) deduct the principal amount of the facility from its capital base.

25. Liquidity facilities under IRBS

(1) An authorized institution which uses the IRBS to calculate its credit risk for securitization exposures shall –

(a) in the case of a liquidity facility provided by it which is rated (whether or not it is an eligible liquidity facility)–

(i) apply [*Schedule 7*] to the facility; and

(ii) apply a CCF of 100% to the facility;

(b) in the case of an eligible liquidity facility provided by it which is unrated and for which no inferred rating is available –

(i) use the SFM to calculate the facility's capital charge;

(ii) subject to *subparagraph (iii)*, apply a CCF of 100% to the facility;

(iii) apply a CCF of 20% to the facility if the facility can only be drawn as specified in *section 24(2)*.

[(2) Provision not used.]

(3) Where an authorized institution satisfies the Monetary Authority that it is not practicable for the institution to calculate K_{IRB} for the purpose of applying the supervisory formula, the institution may, with the prior consent of the Monetary Authority, and until the expiration of such period, or the occurrence of such event, as is specified in that consent, calculate the risk-weighted amount of an eligible liquidity facility by –

(a) applying to the facility the highest risk-weight that would be applied under the use of the STC to calculate credit risk (or the

BSA, if the institution adopts the BSA during its transition to the use of the IRB) to any of the underlying exposures covered by the facility had they not been securitized; and

(b) applying a CCF of –

(i) subject to *subparagraph (iii)*, 50% to the principal amount of the facility if the facility has an original maturity of not more than one year;

(ii) subject to *subparagraph (iii)*, 100% to the principal amount of the facility if the facility has an original maturity of more than one year;

(iii) 20% to the principal amount of the facility if the facility can only be drawn as specified in *section 24(2)*.

(4) Where a liquidity facility provided by an authorized institution does not fall within *subsection (1)(a)* or *(b)* or *(3)*, then the institution shall deduct the principal amount of the facility from its capital base after deduction of any specific provision or partial write-off.

26. Servicer cash advance facilities

(1) Subject to *subsection (2)* and *section [..]*, where a servicer cash advance facility provided by an authorized institution in respect of a securitization transaction, the institution is entitled to full reimbursement of cash advanced under the facility and the entitlement is senior to other claims on cash flows from the pool of underlying exposures, *sections 23, 24* and *25* shall, with all necessary modifications, apply to the determination of the risk-weight and CCF of that servicer cash advance facility as they apply to a liquidity facility.

(2) Where the facility is unconditionally cancellable by the institution without prior notice to the person to whom the facility is provided, then the institution may apply a CCF of 0% to the facility.

(a) [provision not used]

(b) [provision not used]

27. Overlapping facilities

(1) Where an authorized institution provides 2 or more facilities that may be drawn in respect of the same securitization transaction such that –

(a) duplicate coverage is provided in respect of the same underlying exposure ("overlapping portion"); and

(b) a drawing on one such facility precludes the drawing, whether in whole or in part, on another such facility,

then –

(c) that institution, for the purposes of these Rules, is required to –

(i) provide regulatory capital for the overlapping portion on the basis of -

(A) if the facilities are subject to the same CCF, attributing the overlapping portion to any one of the facilities;

(B) if the facilities are subject to different CCFs, attributing the overlapping portion to the facility with the highest CCF; and

(ii) provide regulatory capital for that portion of each of the facilities that is not the overlapping portion.

(2) Where overlapping facilities are provided by different authorized institutions, then each institution shall hold regulatory capital for the maximum amount of the facility.

Division 9 –

Treatment of securitization exposures with early amortization provision

28. Additional capital requirements for originating institutions

(1) Subject to *subsection (3)* and *section 29*, the originating institution in a securitization transaction shall hold regulatory capital against all or a portion of the investors' interest when –

(a) it sells underlying exposures into a structure for the securitization transaction that contains an early amortization provision; and

(b) the underlying exposures are of a revolving nature such that the obligor is permitted to vary the drawn amount and repayments within an agreed limit under a credit line.

[(2) Provision not used.]

(3) Where a securitization transaction has a pool of underlying exposures comprising revolving exposures and term exposures, the originating institution shall apply the relevant early amortization treatment specified in *sections 30* to *34* to that portion of the pool containing the revolving exposures.

29. Exemption from early amortization treatment

The originating institution in a securitization transaction is not required to hold regulatory capital pursuant to *section 28(1)* in any case where –

(a) the securitization transaction includes a replenishment structure under which the underlying exposures that are revolving in nature are to be replenished by exposures that do not revolve and the early amortization ends the ability of the institution to add new underlying exposures;

(b) the securitization transaction contains an early amortization provision that results in the structure of the securitization transaction being akin to a term structure in that the credit risk in respect of the underlying exposures does not return to the institution;

(c) investors in the securitization issues remain fully exposed to future drawings by obligors in respect of the underlying exposures that are revolving in nature such that the credit risk of those exposures does not return to the institution notwithstanding that an early amortization event has occurred; or

(d) the early amortization provision is solely triggered by events not related to the performance of the underlying exposures that are revolving in nature or of the institution.

30. Maximum regulatory capital for investors' interest

The originating institution in a securitization transaction which is subject to early amortization treatment shall hold regulatory capital for the investors' interest to the extent of the greater of –

(a) the regulatory capital required to be held by the institution for its retained securitization exposures;

(b) the regulatory capital required to be held by the institution had the underlying exposures not been securitized.

31. Investors' interest

For the purposes of this Division –

(a) the investors' interest for the originating institution in a securitization transaction using the STS to calculate credit risk for its securitization exposures consists of the investors’ share of -

(i) the principal amount of the drawn balances of the underlying exposures; and

(ii) the credit equivalent amount of the undrawn balances of the underlying exposures determined by allocating the undrawn balances of the underlying exposures between the institution and investors based on the proportion of their respective share of the drawn balances of the underlying exposures;

(b) the investors' interest for the originating institution in a securitization transaction using the IRBS to calculate credit risk for its securitization exposures consists of the investors’ share of –

(i) the principal amount of the drawn balances of the underlying exposures; and

(ii) the EAD of the undrawn balances of the underlying exposures determined by allocating the undrawn balances of securitization exposures between the institution and investors based on the proportion of their respective share of the drawn balances of the underlying exposures.

32. Mechanics of calculating regulatory capital for investors' interest

(1) An originating institution in a securitization transaction using the STS to calculate its credit risk for securitization exposures shall calculate the risk-weighted amount of the investors' interest as the product of –

(a) the investors' interest;

(b) the appropriate CCF determined under *sections 33* and *34*; and

(c) the risk-weight applicable to the underlying exposures (or, if there is more than one type of underlying exposure, the weighted average risk-weight of all of the types of underlying exposures) under the approach used by the originating institution to calculate its credit risk for the type of underlying exposures as if the exposures had not been securitized.

(2) An originating institution in a securitization transaction using the IRBS to calculate its credit risk for securitization exposures shall calculate its capital charge for the investors' interest as the product of –

(a) the investors' interest;

(b) the appropriate CCF determined under *sections 33* and *34*; and

(c) K_{IRB}.

32A. Meaning of controlled early amortization provision, etc.

For the purposes of this Division, an early amortization provision –

(a) is controlled if –

(i) the originating institution in a securitization transaction has an appropriate plan which operates to ensure that it has sufficient capital and liquidity available in the event of an early amortization in respect of the securitization transaction;

(ii) throughout the duration of the securitization transaction, including the early amortization period, the same pro-rata sharing of payments between the originating institution and investors of interest, principal, expenses, losses and recoveries is applied, based on the relative share of the originating institution and the investors in the drawn balances of the underlying exposures outstanding at the beginning of each month;

(iii) the early amortization period set by the originating institution is sufficient for at least 90% of the total debt outstanding under the underlying exposures at the beginning of that period to have been repaid, or to have been recognized by the originating institution as in default by the end of that period; and

(iv) the speed of repayment of amounts due to the investors by the originating institution is no more rapid than would be the case under a straight-line amortization (being the gradual paying-off of a debt in regular instalments of equal amounts) over the period referred to in *subparagraph (iii)*;

(b) is non-controlled if it does not fall within *paragraph (a)*.

33. CCFs for controlled early amortization provision

For the purposes of determining the CCFs to be applied to the investors' interest in a securitization transaction containing a controlled early amortization provision, an authorized institution shall –

(a) divide the underlying exposures into committed and uncommitted credit lines;

(b) apply a CCF of 90% to the investors' interest in respect of the underlying exposures which fall into committed credit lines;

(c) in respect of the underlying exposures that fall into uncommitted credit lines, further divide the exposures into –

   (i) non-retail credit lines;

   (ii) retail credit lines;

(d) apply a CCF of 90% to the investors' interest in respect of the underlying exposures which fall into uncommitted non-retail credit lines;

(e) subject to *paragraphs (f)* and *(g)*, apply the appropriate CCF, determined by reference to the ratio of 3-month average excess spread of the securitization transaction to the trapping point of the excess spread as set out in *Schedule 10*, to the investors' interest in respect of the underlying exposures which fall into uncommitted retail credit lines;

(f) treat the trapping point of excess spread, for the purposes of *paragraph (e)*, as that point at which the SPE in the securitization

transaction is required to retain the excess spread and not pay it out to the originator; and

(g) in any case where the securitization transaction does not require excess spread to be trapped, treat as the trapping point that point which is 4.5 percentage points greater than the excess spread level at which an early amortization is triggered.

34. CCFs for non-controlled early amortization provision

For the purposes of determining the CCFs to be applied to the investors' interest in a securitization transaction containing a non-controlled early amortization provision, an authorized institution shall –

(a) divide the underlying exposures into committed and uncommitted credit lines;

(b) apply a CCF of 100% to the investors' interest in respect of the underlying exposures which fall into committed credit lines;

(c) in respect of the underlying exposures that fall into uncommitted credit lines, further divide the exposures into –

(i) non-retail credit lines;

(ii) retail credit lines;

(d) apply a CCF of 100% to the investors' interest in respect of the underlying exposures which fall into uncommitted non-retail credit lines;

(e) subject to *paragraphs (f)* and *(g)*, apply the appropriate CCF, by reference to the ratio of 3-month average excess spread of the securitization transaction to the trapping point of the excess spread as set out in *Schedule 11*, to the investors' interest in respect of the underlying exposures which fall into uncommitted retail credit lines;

(f) treat the trapping point of excess spread, for the purposes of *paragraph (e)*, as that point at which the SPE in the securitization

transaction is required to retain the excess spread and not pay it out to the originator; and

(g) in any case where the securitization transaction does not require excess spread to be trapped, treat as the trapping point that point which is 4.5 percentage points greater than the excess spread level at which an early amortization is triggered.

[*Division 9A* – Treatment of interest rate and exchange rate contracts

34A. Interest rate and exchange rate contracts

Where an authorized institution has a securitization exposure arising from its entering into an interest rate or exchange rate contract in a securitization transaction, then the institution shall calculate the risk-weighted amount of the contract in accordance with *Division [..]* or *[..]* of *Part [..]*.]

Division 10 –

Treatment of underlying exposures of originating institutions in synthetic securitizations

35. General

This Division shall apply to the calculation by the originating institution in a synthetic securitization that falls within *Schedule 2* of the risk-weighted amount of the entire pool of underlying exposures.

36. Calculation of risk-weighted amount

Subject to *section 37*, the originating institution in a synthetic securitization shall –

(a) subject to *subsections (c) and (d)*, calculate the risk-weighted amount of its underlying exposures for all tranches in the synthetic securitization based on the approach used by the institution to calculate its credit risk for the underlying exposures;

(b) [provision not used]

(c) take into account the effect of credit risk mitigation in respect of the underlying exposures in the synthetic securitization in accordance with the credit risk mitigation requirements of *Part 4*; and

(d) treat the EL amount of the underlying exposures of the institution in the synthetic securitization as zero if the institution uses the IRB to calculate its credit risk.

37. Treatment of maturity mismatches

(1) For the purposes of calculating the risk-weighted amount of the originating institution's underlying exposures in a synthetic securitization where there is a maturity mismatch between the credit protection pursuant to which the credit risk is transferred under the securitization transaction and the underlying exposures, the institution –

(a) subject to *paragraph (b)*, shall apply *section [..]*, with all necessary modifications;

and

(b) shall –

(i) take the maturity of the underlying exposures as being the lesser of –

(A) the longest maturity of any of those exposures; or

(B) 5 years;

(ii) determine the maturity of the credit protection in accordance with *section [..] of Part 4*;]

(iii) disregard any maturity mismatch in respect of its retained securitization exposures that are subject to deduction from its capital base; and

(iv) for all other securitization exposures, apply the maturity mismatch treatment prescribed in *section [..]* of *Part 4.*

(2) Where a synthetic transaction incorporates a call option (other than a clean-up call) that is capable, when exercised, of terminating the transaction and the

purchased credit protection on a specified date, the originating institution shall treat the securitization transaction in accordance with the treatment of maturity mismatch specified in *subsection (1)*.

Division 11 –

Recognition of credit risk mitigation for securitization exposures

38. General

For credit risk mitigation to be recognized for the purposes of this Part, it must fall within-

(a) *section [..]*;

(b) *section [..]*; or

(c) *section [..]*.

39. [Provision not used]

39A. Recognized credit risk mitigation under STS

The originating institution in a securitization transaction which uses the STS to calculate its credit risk for securitization exposures shall calculate the risk-weighted amount of a securitization exposure in respect of which credit protection has been obtained in accordance with *Division [..]* or *[..]* of *Part [..]*.

40. Recognized credit risk mitigation under RBM

The originating institution in a securitization transaction which uses the RBM to calculate its credit risk for rated securitization exposures shall calculate the risk-weighted amount of a securitization exposure in respect of which credit protection has been obtained in accordance with *Division [..]* or *[..]* of *Part [..]*.

41. Recognized credit risk mitigation under SFM – full credit protection

(1) The originating institution in a securitization transaction which uses the SFM to calculate its credit risk for unrated securitization exposures shall determine the effective risk-weight of a securitization exposure by dividing the risk-weighted amount of the exposure (being the product of the capital charge calculated for the exposure under the SFM and 12.5) by the principal amount of the exposure and multiplying the result by 100%.

[(2) Where the originating institution in a securitization transaction which uses the SFM has[, pursuant to *subsection (1)*,] determined the effective risk-weight of a securitization exposure, then the institution shall -]

(a) in the case of funded credit protection –

(i) calculate the risk-weighted amount of the securitization exposure by multiplying the adjusted principal amount of the exposure (after taking into account the credit protection held in respect of it) by that [effective] risk-weight of the exposure;

[(ii) apply *Division [..]* of *Part [..]* to the treatment and recognition of collateral for sovereign, bank and corporate exposures;]

[(iii) apply *Division [..]* of *Part [..]* to the treatment and recognition of collateral for retail exposures; and]

[(iv) apply *Division [..]* of *Part [..]* to the treatment and recognition of collateral for purchased receivables;]]

(b) in the case of unfunded credit protection –

(i) calculate the risk-weighted amount of the exposure by multiplying the adjusted amount of the credit protection (after taking into account any currency mismatch and maturity mismatch) by the risk-weight of the credit protection provider and adding this to the amount arrived at by multiplying the principal amount of the exposure, minus the adjusted amount of the credit protection, by that [effective] risk-weight;

[(ii) applying *Division [..]* of *Part [..]* to the treatment and recognition of [...] for sovereign, bank and corporate exposures;]

[(iii) applying *Division [..]* of *Part [..]* to the treatment and recognition of […] for retail exposures; and]

[(iv) applying *Division [..]* of *Part [..]* to the treatment and recognition of […] for purchased receivables.]]

42. Recognized credit risk mitigation under SFM – partial protection

(1) Where the credit protection for a securitization exposure of an authorized institution using the SFM covers first losses, or losses on a proportional basis in terms of the senior and junior tranches of the exposure, the institution shall –

(a) only reduce the capital charge of the securitization exposure in respect of that portion of the securitization exposure which is covered by the credit protection; and

(b) apply *section 41* to the covered portion.

(2) Where the credit protection for a securitization exposure of an authorized institution is partial but not proportional as specified in *subsection (1)*, the institution shall –

(a) if the amount of credit protection covers all of the senior portion and part of the junior portion –

(i) apply the credit protection as against the senior portion first and then apply any remaining credit protection against the junior portion;

(ii) treat as the uncovered portion any remaining exposures to which the credit protection does not so apply;

(b) treat the exposure as 2 or more securitization positions with the uncovered portion being the position with the lower credit quality;

(c) calculate the risk-weighted amount for the covered portion in accordance with *Division 7*, subject to modifications in respect of the thickness of tranche (*T*) where the principal amount of the

tranche concerned is adjusted for the funded and unfunded credit protection in accordance with *section 41(2)(a)* or *(b)* respectively.

SCHEDULE 1

[*s. 5(1)(a)*]

REQUIREMENTS APPLICABLE TO OR IN RELATION TO ORIGINATING INSTITUTION IN TRADITIONAL SECURITIZATION BEFORE *SECTION 5(1)(a)* OF THESE RULES MAY BE USED

1. The Monetary Authority is satisfied that significant credit risk associated with the underlying exposures of the securitization transaction has been transferred from the originating institution to third parties.
2. The securitization documentation for the securitization transaction accurately reflects the economic substance of the securitization transaction.
3. An adjudication has been sought and obtained from relevant tax authorities on whether any direct or indirect tax obligations arise as a result of any transfer of interests in underlying exposures and related collateral under the securitization transaction.
4. Subject to *section 5*, the underlying exposures of the securitization transaction have been validly transferred and none of the originating institution's or the institution's creditors, or any liquidator or receiver or like officer appointed in respect of the originating institution, is able, or will be able, to avoid, set aside or successfully contest the transfer.
5. The originating institution has obtained an opinion in writing from qualified legal counsel confirming that, in all relevant jurisdictions, the securitization transaction falls within *section 4*.

6. The transfer of underlying exposures from the originating institution in the securitization transaction does not contravene the terms and conditions of any agreement governing the underlying exposures and all necessary consents have been obtained to make the transfer fully effective.

7. The securitization issues under the securitization transaction do not represent payment obligations of the originating institution such that investors who purchase the securitization issues only have recourse for payment to the pool of underlying exposures.

8. The originating institution does not under the securitization transaction maintain effective control, directly or indirectly, over the underlying exposures.

[9. Provision not used.]

10. The securitization issues under the securitization transaction are issued by the SPE and the holders of the securitization issues have the right to pledge or transfer them without restriction.

11. Where there is a clean-up call, it satisfies the requirements of *Schedule 3*.

12. The securitization documentation for the securitization transaction does not contain any clause that –

    (aa) directly or indirectly makes any representation or provides any warranty as to the future performance of the credit exposure;

    (a) obliges the originating institution to repurchase any credit exposure in the underlying exposures, at any time, except where that obligation arises from a claim arising from a representation or warranty given by the originating institution to another person in

the securitization documentation solely in respect of the status of any underlying exposure at the time of the transfer and that is capable of being verified at that time;

(b) requires the originating institution to alter the pool of underlying exposures such that the pool's weighted average credit quality is improved unless this is achieved through the sale of underlying exposures [by the originating institution] to independent and unaffiliated third parties at market prices;

(c) allows for increases in a first loss tranche retained, or credit enhancement provided, by the originating institution after the commencement of the securitization transaction; or

(d) increases the return to parties other than the originating institution, such as investors in securitization issues and third party providers of credit enhancements to the securitization transaction, in response to a deterioration in the credit quality of the pool of underlying exposures.

13. Subject to *section 14*, the originating institution in the securitization transaction has not committed itself to purchasing any of the securitization issues prior to their initial issue by the issuer.

14. Where the originating institution or a member of its group of companies has underwritten any securitization issues in the securitization transaction, this has been done –

(a) at an arm's length basis; and

(b) after consultation with the Monetary Authority, in accordance with a timetable for the disposal of any positions held or to be held under the underwriting commitment.

15. Where under the securitization transaction there is an interest rate or exchange rate contract between the originating institution and the SPE which issued the securitization issues for the purpose of enabling the SPE to hedge interest rate or foreign exchange risk, that contract was entered into at market rates and, notwithstanding that contract, the securitization transaction still meets the requirements set out in this Schedule.

SCHEDULE 2

[*s. 5(1)(b)*]

REQUIREMENTS APPLICABLE TO OR IN RELATION TO ORIGINATING INSTITUTION IN SYNTHETIC SECURITIZATION BEFORE *SECTION 5(1)(b)* OF THESE RULES MAY BE USED

1. The Monetary Authority is satisfied that significant credit risk associated with the underlying exposures of the securitization transaction has been transferred from the originating institution to third parties through funded or unfunded credit protection.
2. The securitization documentation for the securitization transaction accurately reflects the economic substance of the securitization transaction.
3. The credit protection by which the credit risk is transferred under the securitization transaction falls within *section [..]* or *[..]* of *Part 4* of these Rules.
4. Subject to *section 5*, where the originating institution –
   - (a) uses the STS to calculate its credit risk for securitization exposures under the securitization transaction, the funded credit protection must fall within *section [..]* of these Rules;
   - (b) uses the IRBS to calculate its credit risk for securitization exposures under the securitization transaction –
     - (i) the funded credit protection must fall within *section [..]* of these Rules in the case of sovereign, bank and corporate exposures;

(ii) the funded credit protection must fall within *section [..]* of these Rules in the case of retail exposures;

(iii) the funded credit protection must fall within *section [..]* of these Rules in the case of purchased receivables.

5. The prior consent of the Monetary Authority has been obtained in the case of funded credit protection provided by the SPE in the securitization transaction.

6. Subject to *section 7*, where the originating institution –

(a) uses the STS to calculate its credit risk for securitization exposures under the securitization transaction, any credit protection provider for unfunded credit protection must fall within *section [..]* of these Rules;

(b) uses the IRBS to calculate its credit risk for securitization exposures under the securitization transaction –

(i) any credit protection provider for unfunded credit protection must fall within *section [..]* of these Rules in the case of sovereign, bank and corporate exposures;

(ii) any credit protection provider for unfunded credit protection must fall within *section [..]* of these Rules in the case of retail exposures;

(iii) any credit protection provider for unfunded credit protection must fall within *section [..]* of these Rules in the case of purchased receivables.

7. The SPE in the securitization transaction is not recognized as a credit protection provider for unfunded credit protection for the purposes of credit risk mitigation.

8. The instruments used under the securitization transaction to transfer credit risk do not contain any clause that –

    (a) materially limits the credit protection or credit risk transference if a credit event occurs or the credit quality of the pool of underlying exposures deteriorates;

    (b) requires the originating institution to alter the pool of underlying exposures to improve the weighted average credit quality of the pool unless this is achieved through the sale of underlying exposures by the originating institution to independent and unaffiliated third parties at market prices;

    (c) allows for increases in a first loss tranche retained, or credit enhancement provided, by the originating institution after the commencement of the securitization transaction;

    (d) allows for increases in the cost of credit protection to the originating institution in response to deterioration in the overall credit quality of the pool of underlying exposures; or

    (e) increases the return to parties other than the originating institution, such as investors in securitization issues and third party providers of credit enhancements to the securitization transaction, in response to a deterioration in the credit quality of the pool of underlying exposures.

9. The authorized institution has obtained an opinion in writing from qualified legal counsel confirming that, in all relevant jurisdictions, the securitization documentation constitutes valid, legally binding and enforceable obligations of the credit protection provider.

10. Where there is a clean-up call, it satisfies the requirements of *Schedule 3*.

11 Where the originating institution or a member of its group of companies has underwritten any securitization issues in the securitization transaction, this has been done -

   (a) at an arm's length basis; and

   (b) after consultation with the Monetary Authority, in accordance with a timetable for the disposal of any positions held or to be held under the underwriting commitment.

12. Where under the securitization transaction there is an interest rate or exchange rate contract between the originating institution and the SPE which issued the securitization issues for the purpose of enabling the SPE to hedge interest rate or foreign exchange risk, that contract was entered into at market rates and, notwithstanding that contract, the securitization transaction still meets the requirements set out in this Schedule.

SCHEDULE 3

[*s. 11* of *Schedule 1* and
s. 10 of *Schedule 2*]

REQUIREMENTS APPLICABLE FOR SECURITIZATION TRANSACTIONS THAT INCLUDE CLEAN-UP CALLS

1. Where a securitization transaction which falls within *Schedule 1* or *2* includes a clean-up call, the originating institution of the securitization transaction is not required to hold regulatory capital in respect of the clean-up call if -

   (a) the exercise of the clean-up call is entirely at the discretion of the originating institution;

   (b) the clean-up call is not structured –

      (i) for the purpose of reducing potential or actual losses to investors or other parties to the securitization transaction; and

      (ii) to provide credit enhancement to those investors and parties; and

   (c) the clean-up call is exercisable only when –

      (i) in the case of a traditional securitization, 10% or less of the principal amount of the securitization issues or underlying exposures at the commencement of the securitization transaction remains outstanding;

(ii) in the case of a synthetic securitization, 10% or less of the principal amount of the reference pool of underlying exposures at the commencement of the securitization transaction remains outstanding.

SCHEDULE 4

[*s. 12*]

MAPPING OF ECAI ISSUE SPECIFIC RATINGS INTO CREDIT QUALITY GRADES/RISK-WEIGHTS APPLICABLE UNDER STS

TABLE A

LONG-TERM CREDIT QUALITY GRADE (LTCQG) AND RISK-WEIGHTS APPLICABLE TO EACH GRADE

LTCQG	**Standard and Poor's Corporation**	**Moody's Investors Service, Inc.**	**Fitch Ratings Ltd.**	**Risk-weight**
1	AAA AA+ AA AA-	Aaa Aa1 Aa2 Aa3	AAA AA+ AA AA-	20%
2	A+ A A-	A1 A2 A3	A+ A A-	50%
3	BBB+ BBB BBB-	Baa1 Baa2 Baa3	BBB+ BBB BBB-	100%
4	BB+ BB BB-	Ba1 Ba2 Ba3	BB+ BB BB-	350% (for investing institutions) [Deduction from capital base (for originating institutions)]

TABLE A -continued

LTCQG	Standard and Poor's Corporation	Moody's Investor's Service, Inc.	Fitch Ratings Ltd.	Risk-weight
5	B+ B B- CCC+ CCC CCC- CC C D	B1 B2 B3 Caa1 Caa2 Caa3 Ca C	B+ B B- CCC+ CCC CCC- CC C D	[Deduction from capital base]

[NOTE: THE MAPPING LAID OUT IN TABLE A IS FOR ILLUSTRATIVE PURPOSES ONLY.]

TABLE B

SHORT-TERM CREDIT QUALITY GRADE (STCQG) AND RISK-WEIGHTS APPLICABLE TO EACH GRADE

STCQG	Standard and Poor's Corporation	Moody's Investors Service, Inc.	Fitch Ratings Ltd.	Risk-weight
1	A-1	P-1	F-1	20%
2	A-2	P-2	F-2	50%
3	A-3	P-3	F-3	100%
4	Others	Others	Others	[Deduction from capital base]

[NOTE: THE MAPPING LAID OUT IN TABLE B IS FOR ILLUSTRATIVE PURPOSES ONLY.]

SCHEDULE 5

[SCHEDULE NOT USED]

SCHEDULE 6

[SCHEDULE NOT USED]

SCHEDULE 7

[*s. 15*]

MAPPING OF ECAI ISSUE SPECIFIC RATINGS INTO CREDIT QUALITY GRADES/RISK-WEIGHTS APPLICABLE UNDER RBM

TABLE A

LONG-TERM CREDIT QUALITY GRADES (LTCQG) AND RISK-WEIGHTS APPLICABLE TO EACH GRADE

LTCQG	Standard and Poor's Corporation	Moody's Investors Service, Inc.	Fitch Ratings Ltd.	Risk-weight		
				A	B	C
1	AAA, AA+	Aaa, Aa1	AAA,AA+	7%	12%	20%
2	AA,AA-	Aa2, Aa3	AA, AA-	8%	15%	25%
3	A+	A1	A+	10%	18%	35%
4	A	A2	A	12%	20%	35%
5	A-	A3	A-	20%	35%	35%
6	BBB+	Baa1	BBB+	35%	50%	50%
7	BBB	Baa2	BBB	60%	75%	75%
8	BBB-	Baa3	BBB-	100%	100%	100%
9	BB+	Ba1	BB+	250%	250%	250%
10	BB	Ba2	BB	425%	425%	425%
11	BB-	Ba3	BB-	650%	650%	650%
12	Below BB- (i.e. B+, B, B-, CCC+, CCC, CCC-, CC, C and D)	Below Ba3 (i.e. B1, B2, B3, Caa1, Caa2, Caa3, Ca and C	Below BB- (i.e. B+, B, B-, CCC+, CCC, CCC-, CC, C and D)	[Deduction from capital base]		

Where:
risk-weight A denotes risk-weights for senior positions;
risk-weight B denotes risk-weights for securitization positions which do not fall under Column A or Column C; and
risk-weight C denotes risk-weights for tranches backed by non-granular pools (to qualify as granular, the effective number of underlying exposures must be not less than 6).

[NOTE: THE MAPPING LAID OUT IN TABLE A IS FOR ILLUSTRATIVE PURPOSE ONLY.]

TABLE B

SHORT-TERM CREDIT QUALITY GRADES (STCQG) AND RISK-WEIGHTS APPLICABLE TO EACH GRADE

STCQG	Standard and Poor's Corporation	Moody's Investor Service, Inc.	Fitch Ratings Ltd.	Risk-weight		
				A	B	C
1	A-1	P-1	F-1	7%	12%	20%
2	A-2	P-2	F-2	12%	20%	35%
3	A-3	P-3	F-3	60%	75%	75%
4	All other ratings			[Deduction from capital base]		

Where:
risk-weight A denotes risk-weights for senior positions;
risk-weight B denotes risk-weights for securitization positions which do not fall under Column A or Column C; and
risk-weight C denotes risk-weights for tranches backed by non-granular pools (to qualify as granular, the effective number of underlying exposures must be not less than 6).

[NOTE: THE MAPPING LAID OUT IN TABLE B IS FOR ILLUSTRATIVE PURPOSE ONLY.]

SCHEDULE 8

[SCHEDULE NOT USED]

SCHEDULE 9

[SCHEDULE NOT USED]

SCHEDULE 10

[*s. 2(1)*]

CCFS FOR SECURITIZATIONS SUBJECT TO CONTROLLED EARLY AMORTIZATION PROVISION

<table>
<tr><th></th><th colspan="2">Uncommitted</th><th>Committed</th></tr>
<tr><td rowspan="7">Retail credit lines</td><td>3-month average excess spread</td><td>Credit conversion factor (CCF)</td><td rowspan="7">90% CCF</td></tr>
<tr><td>133.33% or more of trapping point</td><td>0% CCF</td></tr>
<tr><td>Less than 133.33% to 100% of trapping point</td><td>1% CCF</td></tr>
<tr><td>Less than 100% to 75% of trapping point</td><td>2% CCF</td></tr>
<tr><td>Less than 75% to 50% of trapping point</td><td>10% CCF</td></tr>
<tr><td>Less than 50% to 25% of trapping point</td><td>20% CCF</td></tr>
<tr><td>Less than 25% of trapping point</td><td>40% CCF</td></tr>
<tr><td>Non-retail credit lines</td><td colspan="2">90% CCF</td><td>90% CCF</td></tr>
</table>

SCHEDULE 11

[*s. 2(1)*]

CCFS FOR SECURITIZATIONS SUBJECT TO NON-CONTROLLED EARLY AMORTIZATION PROVISION

<table>
<tr><td></td><td colspan="2">Uncommitted</td><td>Committed</td></tr>
<tr><td rowspan="6">Retail credit lines</td><td>3-month average excess spread</td><td>Credit conversion factor (CCF)</td><td rowspan="6">100% CCF</td></tr>
<tr><td>133.33% or more of trapping point</td><td>0% CCF</td></tr>
<tr><td>Less than 133.33% to 100% of trapping point</td><td>5% CCF</td></tr>
<tr><td>Less than 100% to 75% of trapping point</td><td>15% CCF</td></tr>
<tr><td>Less than 75% to 50% of trapping point</td><td>50% CCF</td></tr>
<tr><td>Less than 50% of trapping point</td><td>100% CCF</td></tr>
<tr><td>Non-retail credit lines</td><td colspan="2">100% CCF</td><td>100% CCF</td></tr>
</table>

EXPLANATORY NOTE

(Asset Securitization only)

Part 2 – Application of these Rules

1. *Section 3* specifies that an authorized institution must use the standardized approach for securitization ("STS") to calculate its credit risk for securitization exposures (see *Part 7*) if it uses the standardized approach ("STC"), or the basic approach ("BSA"), to calculate its credit risk for the types of underlying exposures that are securitized. That section also specifies that an authorized institution may only use the internal ratings-based securitization approach ("IRBS") to calculate its credit risk for securitization exposures (see *Part 7*) if it uses the internal ratings-based approach ("IRB") to calculate its credit risk for the types of underlying exposures that are securitized. (See the definitions of "standardized approach for securitization", "securitization exposures", "standardized approach", "basic approach", "underlying exposures", "internal ratings-based securitization approach" and "internal ratings-based approach" in *section 2(1)*).

2. *Section 4* specifies that an authorized institution which uses the IRBS to calculate its credit risk for securitization exposures shall use the ratings-based method ("RBM") to calculate the risk-weighted amount of its rated securitization exposures and, with the prior consent of the MA, use the supervisory formula method ("SFM") to calculate the capital charge for its unrated securitization

exposures. (See the definitions of “ratings-based method”, “rated”, “supervisory formula method” and “unrated” in *section 2(1)*).

Part 7 – Securitization

3. *Part 7* relates to securitization. Securitization is a form of structured finance which may enable an authorized institution to, inter alia, remove assets from its balance sheet, improve its financial ratios (for example, debt-to-equity, return on capital or return on assets) or raise capital. Securitization transactions fall into 2 categories – traditional securitization or synthetic securitization. (See the definitions of “securitization transaction”, “traditional securitization” and “synthetic securitization” in *section 2(1)*).

Division 1 – General

4. *Section 5* provides that the originating institution in a traditional securitization may exclude the underlying exposures from the calculation of the risk-weighted amount for its credit exposures and, in a synthetic securitization, may calculate the risk-weighted amount for its credit risk for the underlying exposures in accordance with *Division 10* of *Part 7*. However, before the originating institution may do this, it must have the prior consent of the MA, and the requirements of *Schedule 1* to the Rules must be fulfilled in the case of a traditional securitization and the requirements of *Schedule 2* must be fulfilled in the case of a synthetic securitization. (See the definitions of “originating institution” and “originator” in *section 2(1)*).

5. *Section 6* prohibits the originating institution in a securitization transaction from providing implicit support to investors beyond the institution's contractual obligations, and specifies the action that may be taken by the MA if the originating institution contravenes the prohibition. (See the definition of "implicit support" in *section 2(1)*).

Division 2 **– Calculation of regulatory capital under securitization**

6. *Division 2* specifies that an authorized institution shall calculate the risk-weighted amount of a securitization exposure held by it by applying the relevant risk-weight under the STS or IRBS to the exposure by reference to the exposure's ECAI issue specific rating or otherwise in accordance with the Rules.

Division 3 **– External credit assessments**

7. *Section 8* provides that *sections [..]* of *Part 4* relating to ECAI ratings shall, for the purposes of *Part 7* and with all necessary modifications, apply to and in relation to securitization exposures. However, those sections shall only so apply subject to the provisions of *section 9*.

Division 4 **– Deductions from capital base**

8. *Division 4* specifies the deductions that an authorized institution which uses the STS or IRBS shall make from its capital base.

Division 5 – Maximum capital requirement for originating institution

9. *Section 11* makes it clear that, subject to *section 30*, the regulatory capital required to be held by the originating institution in a securitization transaction in respect of the securitization exposures retained by it shall not exceed the regulatory capital it would have been required to hold in respect of the underlying exposures if the underlying exposures had not been securitized.

Division 5A – Risk-weighting requirements under STS

10. *Section 12*, as read with *Schedule 4* to the Rules, specifies how an authorized institution which uses the STS shall determine the risk-weights to be used under the STS.

Division 6 – Risk-weighting requirements under RBM

11. *Section 15*, as read with *Schedule 7* to the Rules, specifies how an authorized institution which uses the RBM shall determine the risk-weights to be used under the RBM. The basis on which an inferred rating may be attributed to a securitization exposure should be noted. (See *section 16*).

Division 7 – Risk-weighting requirements under SFM

12. *Section 17(1)* requires an authorized institution to allocate that risk-weight for each of its unrated securitization exposures that is the greater of 7% or the risk-weight determined under *Division 7* for the position concerned. The risk-weight determined under *Division 7* for a position is, essentially, determined by the use

of the supervisory formula (being *Formula 2* set out in *section 17*) as read with the technical provisions of *sections 18* to *22*.

Division 8 – Treatment of liquidity/servicer cash advance facilities

13. *Division 8* specifies what constitutes an eligible liquidity facility for the purposes of [*Part 7*] (*section 23*), how an authorized institution which uses the STS or IRBS shall risk-weight its liquidity facilities (*sections 24* and *25*) and how overlapping facilities shall be treated (*section 27*). Section 26 applies sections 23, 24 and 25, with all necessary modifications, to the determination of the risk-weights and credit conversion factors of servicer cash advance facilities.

Division 9 – Treatment of securitization exposures with early amortization provision

14. *Division 9* sets out the requirements applicable to securitization transactions which contain an early amortization provision. (See the definition of "early amortization provision" in *section 2(1)* as read with *section 32A* to ascertain the difference between a controlled and a non-controlled early amortization provision). *Section 28(1)* requires the originating institution in such a securitization transaction to hold additional regulatory capital unless the exemption specified in *section 29* is applicable. *Section 28(3)* provides for a special treatment in the case of such a securitization transaction that has a pool of underlying exposures comprising revolving and term underlying exposures.

Division 9A – Treatment of interest rate and exchange rate contracts

15. *Division 9A* specifies how an authorized institution shall calculate the risk-weighted amount of an interest rate or exchange rate contract entered into by the institution for the purposes of a securitization transaction.

Division 10 – Treatment of underlying exposures of originating institutions in synthetic securitizations

16. *Division 10* applies to the calculation by the originating institution in a synthetic securitization that falls within *Schedule 2* of the risk-weighted amount of the

entire pool of underlying exposures. *Section 37* states what the originating institution shall do in the case of a maturity mismatch.

Division 11 – Recognition of credit risk mitigation for securitization exposures

17. *Division 11* specifies what is recognized credit risk mitigation for the purposes of *Part 7* and how such recognized credit risk mitigation shall be taken into account in calculating the risk-weighted amounts of securitization exposures.

HONG KONG MONETARY AUTHORITY
香港金融管理局

DRAFT

DISCLOSURE RULES CONSULTATION PAPER

APRIL 2006

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1. INTRODUCTION

1.1 Based on the Section 60A of the Banking Ordinance as amended by the Banking (Amendment) Ordinance 2005 which empowers the Hong Kong Monetary Authority (HKMA) to set rules prescribing the information to be disclosed to the general public by Authorized Institutions, the HKMA is inviting comments on all aspects of the proposed disclosure requirements set out as proposed Disclosure Rules in the Attachment.

1.2 Subject to specific provisions prescribed therein, the proposed Disclosure Rules will apply to both Authorized Institutions incorporated in Hong Kong and Authorized Institutions incorporated outside Hong Kong.

1.3 Any comments received from interested parties on the proposed Rules will be reviewed and carefully considered by the HKMA.

1.4 Please send written comments to:

Basel II Team
Banking Policy Department
Hong Kong Monetary Authority
55th Floor
Two International Finance Centre
8 Finance Street
Central
Hong Kong

Or by email to:
Basel2@hkma.gov.hk

By [May 2006]

1.5 Additional copies of this Consultation Paper and the proposed Disclosure Rules are available for download from the HKMA's web site at http://www.hkma.gov.hk.

2. BACKGROUND

2.1 These Disclosure Rules (DRs) set out the minimum disclosure standards that the HKMA expects of Authorized Institutions (AIs) under the Banking Ordinance, covering both Hong Kong incorporated and overseas incorporated AIs. The DRs are intended to come into effect on 1 January 2007 to apply to all Disclosure Statements issued for the semi-annual/interim or annual reporting period beginning on or after 1 January 2007 (i.e. the first set of disclosure statements to which the DRs will be applied will be those relating to the position ending 30 June 2007. For disclosures made before that date, AIs should continue to follow the existing disclosure guidelines referred in section 2.5 below). The Rules also contain transitional provisions.

2.2 The DRs are being made pursuant to Section 60A of the Banking Ordinance (BO) as amended by the Banking (Amendment) Ordinance 2005 (BAO 2005) which empowers the HKMA to make DRs for the purpose of implementing the requirements of the new Capital Adequacy Framework ("Basel II"). In addition, the Rules also provide that where an AI fails to comply with any requirement applicable to it contained in rules made under this power, every director, every chief executive and every manager of the AI commits an offence that may lead to imposition of a financial penalty in accordance with the BAO 2005.

2.3 AIs subject to the disclosure requirements specified in the DRs ("Designated AIs") are referred to as either "Designated Local AIs" (indicating those incorporated in Hong Kong) or "Designated Foreign AIs" (indicating those incorporated overseas) in the DRs. Part 2 of the DRs contains definitions of Designated AIs, including the threshold criteria that the HKMA will apply. AIs that meet the relevant thresholds are not required to comply with the DRs; however, the HKMA encourages them to adopt the disclosure standards set out in the DRs to the greatest extent possible. Where appropriate, the Monetary Authority may consider applying the requirements of these DRs to a controller of a Designated Local AI as assigned to it in section 2 of the BO.

2.4 The HKMA is under a general statutory responsibility to "promote the general stability and effective working of the banking system". The Banking Ordinance currently provides, by Section 60, for the public disclosure of AIs' audited annual accounts. It is also an authorization criterion in the Seventh Schedule of the Banking Ordinance that all AIs incorporated in Hong Kong (except for the smaller restricted licence banks and deposit-taking companies) make adequate disclosure of financial information in their audited annual accounts. While the Companies Ordinance provides the statutory framework for the issuance and external audit of annual accounts by Hong Kong incorporated companies, there is an explicit carve out for banks in the Tenth Schedule of the Companies Ordinance which relates to the preparation of financial accounts.

2.5 AIs are currently subject to the minimum disclosure requirements for annual and interim financial disclosures set out in the guidelines issued by the HKMA under the Banking Ordinance Section 16(10). These guidelines have been issued as modules of the HKMA's Supervisory Policy Manual, FD-1 ("Financial Disclosure by Locally Incorporated Authorized Institutions"), FD-2 ("Interim Financial Disclosure by Locally Incorporated Authorized Institutions") and FD-3 ("Financial Disclosure by Overseas Incorporated Authorized Institutions"). These will be collectively referred to as the "Financial Disclosure Guidelines."

2.6 The DRs will replace the Financial Disclosure Guidelines and will provide the basis on which the HKMA will henceforth expect AIs to make both annual and interim disclosures. Unlike the guidelines that they will replace the DRs will have the form of subsidiary legislation and therefore will have the same legal status as the Capital Rules. The HKMA's intention in drafting the DRs has been to align the disclosures required by the DRs as closely as possible with those in the Financial Disclosure Guidelines. Nonetheless, some changes have been inevitable.

3. REVISIONS TO EXISTING DISCLOSURE REQUIREMENTS

3.1 Three developments in particular have meant that revisions have needed to be made to the HKMA's existing disclosure requirements:

(a) the impact of accounting changes, especially the enhanced disclosures under Hong Kong Financial Reporting Standard 7 (HKFRS 7) [1] and Amendment to Hong Kong Accounting Standard 1 (HKAS 1)[2];

(b) additional information suggested by users of Financial and Disclosure Statements during the preliminary consultation process in order to keep Hong Kong AIs' disclosure in line with best practices elsewhere; and

(c) enhanced disclosures needed to bring Hong Kong requirements broadly into line with the recommendations contained in Pillar 3 of Basel II.

3.2 A major development since the Financial Disclosure Guidelines were last revised has been the enhancement of disclosures required under Hong Kong accounting standards, in particular HKFRS 7 *Financial Instruments: Disclosures.* Accordingly, the HKMA has used the opportunity presented in drafting the DRs to align its disclosure requirements for AIs with these general accounting disclosures. It should be emphasised, however, that it is not the HKMA's intention to require AIs to make duplicative disclosures. To the extent that the disclosure requirements of the DRs map to those required by the

[1] HKFRS 7 *Financial Instruments: Disclosures*
[2] Amendment to HKAS 1 *Capital Disclosures*

accounting standards, the HKMA will consider that its requirements have been met by AIs' disclosures made under the relevant accounting standards. In addition to the statutory responsibility of the HKMA on ensuring adequacy of disclosures by AIs highlighted in 2.4 above, the HKMA's aim in incorporating the accounting disclosures into its DRs is primarily to be able to provide an additional level of detail and guidance on the form that these disclosures should take in the specific case of AIs. In this connection, the HKMA has prepared a Guideline on Operation of the Disclosure Rules (enclosed at Annex to the Draft DRs) to facilitate ease of interpretation for all Designated AIs of the DRs.

3.3 In preparing the current draft of the DRs, the HKMA has also held a number of discussions with various users of Financial and Disclosure Statements (e.g. rating agencies and equity analysts) to ensure that its disclosure requirements continue to meet their needs. These discussions have indicated that there is a strong demand on the part of analysts for greater information on the extent of AIs' mainland exposures. This reflects market developments since the HKMA first issued its Best Practice Guide on Financial Disclosures by Authorised Institutions in 1994. Accordingly, the HKMA has accommodated this demand by enhancing disclosures about AIs' mainland exposures as part of the supplementary information disclosures under the DRs.

3.4 These draft DRs have also been revised to take into account comments from both Members of the Working Party on Financial Disclosure and the Basel II Consultation Group as well as Members of the Technical Working Group on Financial Disclosure during preliminary consultation. In the light of the general concern raised by some AIs and members of the accounting profession with respect to the relationship between the DRs and potential future changes to the relevant accounting standards, the HKMA's presumption in this context will be that the DRs should continue to reflect the relevant accounting requirements. The HKMA will only adopt DRs that are at variance with the relevant accounting standards when there is some overriding reason for it to do so, based on the HKMA's statutory objectives. To ensure that the DRs continue to remain aligned with the relevant accounting standards the HKMA has undertaken to conduct regular reviews of its disclosure requirements for AIs in collaboration with the Hong Kong Institute of Certified Public Accountants (HKICPA).

4. PILLAR 3 DISCLOSURES UNDER BASEL II

4.1 The third, and most important, factor influencing the disclosures required under the DRs has been the recommendations contained in Pillar 3 of Basel II. The three pillars of Basel II are intended to be mutually reinforcing, and thus Pillar 3 complements the minimum capital requirements contained in Pillar 1 and the supervisory review process in Pillar 2. The disclosures required under Pillar 3 aim to supplement supervision through enhanced transparency and market discipline. Accordingly, Pillar 3 sets out disclosure requirements that

are intended to allow market participants to obtain key pieces of information on the capital, risk exposures, risk assessment processes, and hence the capital adequacy of banks.

4.2 In line with the Pillar 3 recommendations, the HKMA intends to introduce a larger risk-based element into AI's financial disclosures than hitherto. The guiding principle adopted by the HKMA's revisions to its disclosure regime has been that different disclosure requirements should apply to different capital adequacy approaches. AIs which adopt the Basic Approach to the calculation of credit risk will be subject to disclosure requirements that are fundamentally little changed from the current Financial Disclosure Guidelines, with the exception of additional disclosures required in respect of operational and market risks. By contrast, additional disclosures will be required of AIs adopting the more sophisticated approaches, with the most intensive disclosures being required of AIs using the Internal-ratings Based (IRB) approaches.

4.3 The HKMA believes that it is appropriate for the disclosures made by AIs adopting the Standardised and IRB approaches to reflect the full range of risks to which these institutions are potentially exposed. Thus the additional disclosures that will be required of them will include qualitative and quantitative elements of credit risk, market risk, operational risk and interest rate risk. In reaching this conclusion the HKMA has carefully balanced the additional costs involved in such disclosures with the benefits in terms of enhanced market discipline that it believes will result.

4.4 AIs adopting the Standardised Approach will be required to make more extensive disclosures than Basic Approach institutions, particularly relating to derivatives and counterparty credit risk, credit risk mitigation, asset securitisation, market risk, operational risk and interest rate risk in the banking book. These enhanced disclosures reflect both the relatively more sophisticated nature of these institutions' business, and the broader range of risks captured by the Standardized Approach compared to its predecessor.

4.5 The most extensive disclosures will be required of AIs adopting the IRB approaches, given the sophistication of these AIs' business operations and the comparatively broad range of risks that they incur. Although the disclosure requirements for IRB banks are broadly similar to those banks adopting the Standardized Approach, the key difference between them is the greater level of detail required in the disclosures made by IRB banks. In particular, IRB banks will be required to make sufficient additional disclosures, both qualitative and quantitative, to enable market participants to form a considered view of the robustness and effectiveness of their internal risk rating systems. They will also be required to make additional disclosures in terms of risk exposures by risk bucket, as well as their methodology in calculating loan loss estimates and provisions. The HKMA believes that a relatively high

degree of disclosures by IRB banks is in keeping with the spirit of Basel II.

4.6 The HKMA recognises that several AIs that will adopt the IRB approach are subsidiaries of overseas parents. Accordingly, it is possible that the parent bank may make disclosures – particularly qualitative disclosures concerning internal ratings systems – that are intended to apply on a group-wide basis. Where this is the case, the AIs are required to satisfy the HKMA that the disclosures made by the overseas parent have met the disclosure requirements in these DRs. In addition, group-level disclosures must provide sufficient detail that it is possible for third parties clearly to identify the range of risks being incurred by the Hong Kong operations of these banking groups, and to understand how those risks are managed.

4.7 As far as overseas incorporated AIs are concerned, with the exception of additional disclosures relating to mainland exposures as already described in paragraph 3.3 above, there will be little change to the substance of the required disclosures. However, the proposal to include the disclosure requirement for overseas incorporated AIs into the DRs has the effect of making these requirements a statutory requirement under the revised disclosure framework.

5. IMPLEMENTATION APPROACH

5.1 **No audit** of disclosures made under the DRs is required unless otherwise required by accounting or other statutory requirements. The HKMA has endeavoured to ensure that the definitions used in these DRs are consistent with the definitions used in the relevant accounting standards, on the one hand, and the Capital Rules on the other. The HKMA's intention is that any terms and definitions not specifically defined in the DRs will have the same meaning and interpretation as that applied under the Capital Rules. The HKMA will also provide additional guidance and clarification in the corresponding guidelines to the DRs.

5.2 Pillar 3 disclosures applicable to Designated Local AIs are only required on an **annual basis** instead of more frequent disclosure recommended by the Basel Committee. This variation represents the pragmatic approach adopted by the HKMA in implementing Basel II in Hong Kong and help ensuring that the HKMA's disclosure requirements are in line with those required by other leading regulators such as the Financial Services Authority in the United Kingdom.

5.3 Subject to a few exceptions specified in Part 2 of the Attachment, the DRs will apply at the top consolidation group level of a Designated Local AI on the basis of consolidation for capital adequacy purposes.

5.4 All Designated AIs are required to publish a Disclosure Statement containing the disclosures required under these DRs. The Disclosure Statement can be published either as a stand-alone document or, for Designated Local AIs that are listed in Hong Kong, as an Annex to the AI's Annual and interim report. AIs may publish all the required information in the Disclosure Statement or provide a summary of the disclosures with complete information being made available on the AI's publicly accessible internet web site (including the disclosures made by overseas parents on which an AI relies in fulfilling the disclosure requirements in these DRs). In the latter case, AIs should ensure the information included in the summary of the Disclosure Statement is presented in a sufficient reliable manner and not misleading in any material aspect for the public understanding of the AI's position. AIs should also include a statement in the summary of the Disclosure Statement concerning the location where all the required information can be found. An example of the specimen disclosure templates is included in the Guideline on Operation of the Disclosure Rules for AIs' reference.

5.5 For AIs that are not required to comply with the disclosure requirements set out in the DRs, the HKMA encourages them to comply with the disclosure requirements to the greatest extent possible. Copies of any disclosure documents that they prepare should be lodged with the HKMA, so that they can be included in its public registry maintained under Section 20 of the BO.

5.6 As the DRs will be made under Section 60A of the BO as amended by the BAO 2005 there will be clear checks and balances on the HKMA's exercise of its rule-making power. The HKMA will be obliged to issue a draft of the proposed DRs to, and invite comments from, the Hong Kong Association of Banks, the DTC Association, the Banking Advisory Committee and the Deposit-taking Companies Advisory Committee. The HKMA will also need to consult the Financial Secretary before issuing the DRs, and may consult other interested parties (such as the Hong Kong Institute of Certified Public Accountants) as the HKMA considers appropriate. The DRs will have the status of subsidiary legislation and hence will be subject to negative vetting by the Legislative Council.

5.7 The HKMA will continue to keep its disclosure requirements under review, and will take into account subsequent future developments, including the implementation approaches being taken by other regulators overseas and international accounting changes. The content of the DRs will also be kept under regular review by the HKMA with the HKICPA as appropriate, and necessary amendments and additions may be issued by the HKMA to keep the regime up-to-date in light of industry, accounting developments and evolving international practice.

6. STRUCTURE OF THIS CONSULTATION DOCUMENT

6.1 Provision

6.1.1 The draft Rules contained in the Attachment to this consultation paper may be cited as the draft DRs.

6.1.2 The DRs should be read in conjunction with other HKMA guidance papers regarding Basel II implementation, in particular those related to the Capital Rules.

6.2 Structure and Format of the Disclosure Rules

6.2.1 The DRs are presented in a menu-approach format designed to facilitate AIs to apply with respect to the specific credit risk approach(es) applicable to the AI's own circumstances. For ease of application, the DRs are divided into eight parts as follows:

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Part 3 - Annual and Interim Financial Disclosures Applicable to Designated Local AIs

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Part 7 - Half Yearly Disclosures by Designated Foreign AIs

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Attachment

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DISCLOSURE RULES

HONG KONG MONETARY AUTHORITY

APRIL 2006

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DISCLOSURE RULES

(Made by the HKMA under section 60A of the
Banking Ordinance (Cap. 155) as amended by the
Banking (Amendment) Ordinance 2005)

PART 1
PRELIMINARY

1.1 Commencement and Status

1.1.1 Provision should be made for the Rules to come into operation on a day to be appointed by the Secretary for Financial Services and the Treasury by notice published in the Gazette.

1.2 Interpretation[1]

1.2.1 Any term or expression used in the Disclosure Rules that is not defined in the Disclosure Rules:

(a) which is defined in the [Capital Rules] shall, unless the context otherwise requires, have the meaning given to it by the [Capital Rules];

(b) which is not defined in the [Capital Rules] and which is defined in the Banking Ordinance shall, unless the context otherwise requires, have the meaning given to it by the Banking Ordinance.

1.2.2 The DRs should include an interpretation section setting out definitions of technical terms along the following lines:

"Advanced IRB Approach" means that, where an AI is using the IRB for non-securitization exposures, the AI provides its own estimates of PD, LGD and EAD and measures the effective maturity of its corporate, sovereign and bank exposures;

"AIRB" means the Advanced IRB Approach;

"AI" means authorized institution, as defined in section 2 of the BO;

[1] The definitions set out in this section are subject to further refinements as necessary and appropriate.

"alternative standardized approach", in relation to the calculation of an AI's operational risk, means the method of calculating that risk set out in Division 3 of Part 7 of the Capital Rules;

"ASA" means the alternative standardized approach;

"asset-backed commercial paper programme" means a programme under which a bankruptcy-remote SPE in a securitization transaction issues debt securities –

(a) with an original maturity of not more than one year; and

(b) the payments in respect of which are secured by a pool of underlying exposures acquired from third parties and held by, or to the order of, that SPE;

"asset sale with recourse", in relation to an AI, 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;

"associate" means an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture;

"available-for-sale", in relation to a financial asset or financial instrument, has the meaning assigned to it by Hong Kong Accounting Standard 39;

"bank" means:

(a) an AI except an AI the authorization of which is for the time being suspended under section 24 or 25 of the BO; or

(b) a bank incorporated outside Hong Kong which is not an AI except -

    (i) such a bank which, in the opinion of the HKMA, is not adequately supervised by the relevant banking supervisory authority; or

    (ii) such a bank the licence or other authorization of which to carry on banking business is for the time being suspended;

"banking book", in relation to an AI, 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;

"BAO" means Banking (Amendment) Ordinance 2005;

"Basel II" means The International Convergence of Capital Measurement and Capital Standards: A Revised Framework published by the Basel Committee on Banking Supervision in June 2004 and updated in November 2005;

"basic approach", in relation to the calculation of an AI's credit risk, means the method of calculating that risk for non-securitization exposures set out in Part [5] of the Capital Rules;

"basic indicator approach", in relation to the calculation of an AI's operational risk, means the method of calculating that risk set out in Division 1 of Part 7 of the Capital Rules;

"BIA" means the basic indicator approach;

"BO" means Banking Ordinance (Cap.155);

"BSA" means the basic approach;

"capital base", in relation to an AI, means the capital base of the institution as defined in section 2(1) of the BO, and should be read with reference to "capital base" in the definition of "capital adequacy ratio" in that section;

"Capital Rules" means the rules made by the HKMA under section 98A of the BO as amended by the BAO 2005;

"CAR" means capital adequacy ratio;

"cash flow hedge", means the hedging relationship defined in paragraph 86 of Hong Kong Accounting Standard 39;

"certificate of deposit" means all certificates of deposit regardless of maturity and includes those certificates of deposit that are held for trading purposes;

"collective provisions", in relation to the on-balance sheet assets of an AI, means an allowance for impairment loss arising from a collective assessment of the assets for impairment loss in accordance with Hong Kong Accounting Standard 39;

"commodities", in relation to the calculation of an AI's market risk, means any precious metals (other than gold), base metals, non-precious metals, energy or agricultural

assets, or any other physical products which are, or can be, traded on an exchange;

"confidence interval" means a statistical range within a specified probability that a given parameter lies within the range;

"consolidation group", in relation to an AI, means -

(a) the institution; and

(b) such subsidiaries of the institution as are specified in a section 98(2) requirement given to the institution;

"core capital", in relation to an AI, means the sum, calculated in Hong Kong dollars, of the book values of the institution's capital items specified in the Capital Rules;

"corporate" means:

- a partnership or limited company; or
- an unincorporated business owned by a single person;

which is neither -

- a public sector entity, bank or securities firm; nor
- an obligor to which the institution has an exposure falling within the definition of "regulatory retail exposure" or the IRB exposure class for retail exposures or IRB exposure class for other exposures in the Capital Rules;

"credit conversion factor", in relation to an off-balance sheet exposure of an AI, 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-enhancing interest-only strip", in relation to a securitization transaction, means an on-balance sheet asset –

(a) recorded by the originator in the securitization transaction as representing the expected future excess spread to be derived from the underlying exposures; and

(b) that is subordinated to claims from other parties to the securitization transaction in terms of the priority of repayment;

"credit-enhancing I/O" means a credit-enhancing interest-only strip;

["credit equivalent amount", in relation to an off-balance sheet exposure of an AI, means the value obtained by –

(a) in the case of an exposure that is not an over-the-counter 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 over-the-counter derivative transaction or credit derivative contract, adding the current exposure of the over-the-counter derivative transaction or credit derivative contract, as the case may be, to the potential exposure of the over-the-counter derivative transaction or credit derivative contract, as the case may be;

In the case of IRB, the deduction of specific provisions is not required in respect of non-over-the-counter derivative transaction or credit derivative contract;]

"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 risk", in relation to an AI, 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 BO;

"credit risk components" means estimates of PD, LGD, EAD and effective maturity, which are inputs into the IRB risk-weight functions to determine the risk-weight to be allocated to corporate, sovereign, bank, retail, or, if the PD/LGD approach is used, equity exposures;

"credit risk weighted amount", in relation to the AI's calculation of credit risk, means the risk-weighted amount of credit exposures calculated in accordance with the

Capital Rules set out in Part 4, [5] and [6] relating to STC, BSA and IRB respectively; and the risk-weighted amount of securitization exposures calculated in accordance with the Capital Rules set out in Part [9] relating to IRBS and STS;

"current" -

(a) in relation to an ECAI issuer rating, means the credit assessment rating concerned has not been withdrawn, and 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 has not been withdrawn, and 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 AI which is an over-the-counter derivative transaction (referred to in this definition as "existing transaction") or credit derivative contract (referred to in this definition as "existing contract"), means the replacement cost:

(a) which would be incurred by the institution if it were required to enter into another over-the-counter 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;]

"Delta Equivalent Approach", means using the delta equivalent value of the option contracts for reporting, which is calculated by multiplying the principal value of the underlying by the delta;

"derivatives", has the meaning assigned to it by Hong Kong Accounting Standard 39;

"Designated AI", in relation to the DRs made under section 60A of BO, means an AI which is incorporated in Hong Kong or outside Hong Kong, as the case may be, and subject to the disclosure requirements applicable to Hong Kong incorporated AIs in accordance with 2.1.1 of Part 2, or overseas incorporated AIs in accordance with 2.1.3 of Part 2, as the case may be, as specified in these DRs;

"direct credit substitute", in relation to an AI -

- 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
- includes:
  - guarantees by the institution;
  - standby letters of credit serving as financial guarantees for loans;
  - acceptances; and
  - 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;

"Disclosure Statement", in relation to an AI, means a document published by that AI under the Disclosure Rules;

"drawn balances", in relation to the calculation of investors' interest, means the amounts of revolving credit lines that have been drawn by the obligors of the credit lines, where –

(a) the credit lines have been sold into a securitization transaction; and

(b) the investors remain, in whole or in part, exposed to future drawings by the obligors under the credit lines available to the obligors;

"DRs" means Disclosure Rules;

"DTC" means a deposit-taking company;

"EAD" means exposure at default;

"early amortization provision", in relation to a securitization transaction of which the underlying exposures are revolving in nature, means a mechanism which, once triggered, allows investors in the securitization transaction to be paid out prior to the originally stated maturity of the securitization issues;

"ECA" means export credit agencies;

"ECAI" means an external credit assessment institution;

"ECAI issuer rating", in relation to any person (howsoever described), means a 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 –

(a) in sections 4.3.1 and 4.3.3 of Part 4 of the Capital Rules, a long-term credit assessment rating assigned to the obligation by an ECAI; and

(b) in sections 4.3.4, 4.3.5 and 4.3.6 of Part 4 of the Capital Rules, a short-term or long-term credit assessment rating assigned to the obligation by an ECAI;

"effective interest method", has the meaning assigned to it by Hong Kong Accounting Standard 39;

"effective interest rate", has the meaning assigned to it by Hong Kong Accounting Standard 39;

"EL" means expected loss;

"EL amount" means expected loss amount;

"eligible provisions", in relation to an exposure of an AI which uses the IRB to calculate its credit risk for non-securitization exposures, means the sum of –

(a) the AI's regulatory reserves for general banking risks, specific provisions, partial write-offs and collective provisions that are attributed to exposures which are subject to the IRB; and

(b) any discounts on exposures referred to in paragraph (a) which are in default;

"EP" means eligible provisions;

"excess spread", in relation to a securitization transaction, means future interest and other income derived by the SPE in the securitization transaction from the underlying exposures of the securitization transaction in excess of the transaction costs specified in the securitization documentation;

"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;

"expected loss", in relation to an exposure of an AI which uses the IRB to calculate its credit risk for non-securitization exposures, means the ratio of the expected loss on the exposure arising from the potential default of the obligor or dilution risk in respect of the exposure over a one year period relative to the EAD of the exposure;

"expected loss amount", in relation to an exposure of an AI which uses the IRB to calculate its credit risk for non-securitization exposures, means the expected loss amount of the exposure calculated by multiplying the EL of the exposure by the EAD of the exposure;

"exposure at default", in relation to an exposure of an AI which uses the IRB to calculate its credit risk for non-securitization exposures, means the expected amount of the exposure:

(a) upon the default of the obligor of the exposure; and

(b) measured without deduction of specific provisions and partial write-offs;

"external credit assessment institution" means:

(a) [Standard and Poor's Corporation];

(b) [Moody's Investors Service, Inc.]; or

(c) [Fitch Ratings Ltd.];

"fair value":

(a) in relation to an asset, means the amount for which the asset could be exchanged between knowledgeable, willing parties in an arm's length transaction;

(b) in relation to a liability, means the amount for which the liability could be settled between knowledgeable, willing parties in an arm's length transaction;

"fair value hedge", means a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss;

"financial assets or financial liabilities measured at fair value through profit or loss" has the meaning assigned to it by Hong Kong Accounting Standard 39;

"FIRB" means the Foundation IRB Approach;

"forecast transaction" has the meaning assigned to it by paragraph 9 of Hong Kong Accounting Standard 39;

"forward asset purchase", in relation to an AI -

(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 AI, 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;

"Foundation IRB Approach" means that, where an AI is using the IRB for non-securitization exposures, the AI provides its own estimates of PD and uses supervisory estimates for the other credit risk components of its corporate, sovereign and bank exposures;

"gain-on-sale", in relation to a securitization transaction, means any increase in the core capital of the originating AI resulting from the sale of underlying exposures in the securitization transaction;

"geographical segment" is a distinguishable component of an entity that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments.

Factors that shall be considered in identifying geographical segments include:

(a) similarity of economic and political conditions;

(b) relationships between operations in different geographical areas;

(c) proximity of operations;

(d) special risks associated with operations in a particular area;

(e) exchange control regulations; and

(f) the underlying currency risks.

“guarantee” includes an indemnity;

“haircut”, in relation to an AI, 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;

“hedges of net investments in foreign operation” means the hedging relationship defined in Hong Kong Accounting Standard 39 where –

(a) Foreign operation is an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity; and

(b) Net investment in a foreign operation is the amount of the reporting entity’s interest in the net assets of that operation;

“held-to-maturity investment” has the meaning assigned to it by Hong Kong Accounting Standard 39;

“highly probable forecast transaction”, in relation to cash flow hedges, means a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss;

“HKAS” means Hong Kong Accounting Standard;

“HKFRS” means Hong Kong Financial Reporting Standard;

“Hong Kong Financial Reporting Standards” mean standards of accounting issued by the Hong Kong Institute of Certified Public Accountants pursuant to section 18A of the Professional Accountants Ordinance (Cap. 50);

“IMA” means internal models approach;

“interest rate contract” means a single-currency forward rate, interest rate swap, interest rate option or similar derivative contract;

“internal model”, in relation to the use by an AI of the IMA to calculate its market risk, means a statistical model used by the institution to measure the institution’s market risk exposures;

“internal models approach”, in relation to the calculation of an AI’s market risk, means the method of calculating that risk set out in the Capital Rules;

“internal ratings-based approach”, in relation to the calculation of an AI’s credit risk for non-securitization exposures, means the method of calculating that risk set out in Part [6] of the Capital Rules;

“internal ratings-based securitization approach”, in relation to the calculation of an AI’s credit risk for securitization exposures, means the method of calculating that risk set out in Part [9] of the Capital Rules;

“investment property” means property (land or a building, or part of a building, or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business;

“investor”, in relation to a securitization transaction, means a person, other than the originator, who assumes securitization exposures by –

(a) purchasing securitization issues;

(b) providing credit protection to other parties to the securitization transaction; or

(c) providing liquidity facilities in respect of the transaction;

“investors’ interest”, in relation to a securitization transaction of which the underlying exposures are revolving in nature and which has an early amortization provision, means the interest held by investors in the underlying exposures of the securitization transaction;

“I/Os” means interest-only strip;

“IRB” means the internal ratings-based approach;

“IRBS” means the internal ratings-based securitization approach;

“IRRBB”, in relation to an AI, means interest rate risk in banking book;

“LGD” means loss given default;

“loan capital” means subordinated liabilities such as loans, debentures, floating rate notes etc;

“loans and receivables” has the meaning assigned to it by Hong Kong Accounting Standard 39;

“long lease”, has the meaning assigned to it by the Tenth Schedule of the Companies Ordinance (Cap. 32);

“loss given default” in relation to an exposure of an AI which uses the IRB to calculate its credit risk for non-securitization exposures, means the ratio of the loss likely to be incurred by the AI upon default of the obligor of the exposure to the EAD of the exposure;

"market risk", in relation to an AI, 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 BO;

“medium-term lease” has the meaning assigned to it by the Tenth Schedule of the Companies Ordinance (Cap. 32);

“net credit exposure”, in relation to an on-balance sheet asset or off-balance sheet exposure of an AI, 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;

“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 AI, means the reference amount used to calculate payment streams between the parties to the exposure;

“obligor grade” means a risk category within the obligor rating scale of an AI’s rating system (as measured by PD) representing an assessment of the risk of obligor default to which obligors are assigned on the basis of a specified and distinct set of internal rating criteria and from which estimates of PD are derived;

“operational risk”, in relation to an AI, 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 BO;

“originating AI”, in relation to a securitization transaction, means the originator is an AI;

“originator”, in relation to a securitization transaction, means a person who -

(a) directly or indirectly originates the underlying exposures included in the securitization transaction; or

(b) serves as a sponsor of an asset-backed commercial paper programme, or a programme with similar features;

“over-the-counter 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) -

  (i) which is traded on an exchange; and

  (ii) which is subject to daily re-margining requirements;

“parent bank”, in respect of an AI, means the highest level of holding company of the AI, which is authorized as a bank in its home country, in the corporate structure of the group of companies of which the AI is a member;

“PD” means the probability of default;

“PD/LGD approach”, in relation to an equity exposure of an AI, means the use of the IRB to calculate the institution’s credit risk in respect of equity exposures as specified in the Capital Rules;

"pool" means a category of homogeneous exposures which have similar obligor and transaction characteristics, with identical PD, LGD and EAD estimates;

"potential exposure", in relation to an off-balance sheet exposure of an AI which is an over-the-counter 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;

"premises and equipment expense", in relation to an AI's operating expenses, includes rents and rates, insurance of premises and equipment, lighting, heating, maintenance costs and electronic data processing expenses;

"principal amount":

(a) in relation to an on-balance sheet asset of an AI, means the current book value (including accrued interest or revaluations) of the asset;

(b) in relation to an off-balance sheet exposure of an AI, means:

    (i) subject to subparagraph (ii), in the case of an exposure listed in Table 4.4.1 of Part 4 of the Capital Rules, the contracted amount of the exposure;

    (ii) in the case of an exposure listed in Table 4.4.1 of Part 4 of the Capital Rules 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 4.4.2 of Part 4 of the Capital Rules, the notional amount of the exposure;

    (iv) in the case of an exposure listed in Table 4.4.2 of Part 4 of the Capital Rules 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;

"probability of default", in relation to an exposure of an AI which uses IRB to calculate its credit risk for non-securitization exposures, means the probability of default of the obligor of the exposure over a one-year period;

"property, plant and equipment" are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period;

"public sector entity" means –

[(a) an entity specified in Part 4 of Schedule 1.1 of the Capital Rules; or]

(b) an entity 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;

"publish" includes distribute, make available and disseminate;

"rating system" means all of the methods, models, processes, controls, and data collection and information technology systems used by an AI that enable the assessment of credit risk, the assignment of internal risk ratings, and the quantification of default and loss estimates by the AI;

["recognized collateral", where the AI -

(A) uses the STC to calculate its credit risk for non-securitization exposures, means –

(a) collateral falling within section 4.5.3 of Part 4 of the Capital Rules in relation to the simple approach to the treatment of collateral;

(b) collateral falling within section 4.5.4 of Part 4 of the Capital Rules in relation to the comprehensive approach to the treatment of collateral;

(B) uses the IRB to calculate its credit risk for non-securitization exposures, means the collateral which meets the requirements set out in Part [6] of the Capital Rules and the relevant minimum requirements set out in section 4.5.1 of Part 4 of the Capital Rules;]

["recognized credit derivative contract", where the AI –

(A) uses the STC to calculate its credit risk for non-securitization exposures, means -

(a) a credit derivative contract falling within section 4.9.3(1) of Part 4 of the Capital Rules;

(b) a credit derivative contract falling within section 4.9.3(2) or (3) of Part 4 of the Capital Rules to the extent that it is deemed under that section to be a recognized credit derivative contract;

(B) uses the IRB to calculate its credit risk for non-securitization exposures, means –

(a) a credit derivative contract falling within Part [6] of the Capital Rules in the case of corporate, sovereign and bank exposures under FIRB and for equity exposures;

(b) a credit derivative contract falling within Part [6] of the Capital Rules in the case of corporate, sovereign and bank exposures under AIRB and for retail exposures;]

"recognized credit risk mitigation", in relation to the on-balance sheet assets or off-balance sheet exposures of an AI, means the use by the institution of recognized collateral, recognized netting, recognized guarantees or recognized credit derivative contracts, 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 the Capital Rules;

["recognized guarantee", where the AI –

(A) uses the STC to calculate its credit risk for non-securitization exposures, means a guarantee falling within section 4.9.2 of Part 4 of the Capital Rules;

(B) uses the IRB to calculate its credit risk for non-securitization exposures, means –

(a) a guarantee falling within Part [6] of the Capital Rules in the case of corporate, sovereign and

bank exposures under FIRB and for equity exposures;

(b) a guarantee falling within Part [6] of the Capital Rules in the case of corporate, sovereign and bank exposures under AIRB and for retail exposures;]

“recognized netting” means any netting done pursuant to a valid bilateral netting arrangement;

“regulatory capital [requirements]” in respect of an AI, means the amount of capital the AI is required to hold in respect of its risk-weighted assets and risk-weighted exposures;

“relevant risk”, in relation to an AI, means the credit risk, operational risk or market risk of the institution;

“repossessed assets” means assets in respect of which an AI has acquired access or control (e.g. through court proceedings or voluntary actions by the obligors concerned) for release in full or in part of the obligations of the obligors. Repossessed assets include properties and securities. In case of properties, voluntary surrender of keys by mortgagors is deemed to render the relevant properties repossessed;

“repo-style transaction”, in relation to an AI, 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;

"restricted securities regulator" means a securities regulator specified in Part 8 of Schedule 1.1 of the Capital Rules;

"risk-weight function" means a formula used to determine the risk-weight to be allocated to an AI's corporate, sovereign, bank and retail exposures and, if the PD/LGD approach is used, equity exposures;

["risk-weighted", in relation to the calculation of a relevant risk of an AI:

(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 of the Capital Rules 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 of the Capital Rules in the case of credit risk;]

"RLB" means restricted licence bank;

"section 98(2) requirement", in relation to an AI, means a requirement in a notice under section 98(2) of the BO whereby the capital adequacy ratio of the institution is to be calculated on –

(a) a consolidated basis in respect of all the subsidiaries of the institution;

(b) a consolidated basis in respect of such subsidiaries of the institution as are specified in the notice;

(c) the consolidated basis referred to in paragraph (a) and an unconsolidated basis; or

(d) the consolidated basis referred to in paragraph (b) and an unconsolidated basis unless otherwise specified in the notice;

"securities firm" -

(a) means an entity –

    (i) authorized 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 AIs under the BO and the Capital 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 not held for trading purposes", in relation to an AI, means securities:

(a) held by the institution other than those which are acquired principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

(b) designated by the institution as securities not held for trading purposes;

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

"securitization exposure", in relation to an AI, means the institution's exposure to a securitization transaction in its banking book; and includes such an exposure arising from -

(a) the purchase or acquisition of securitization issues for investment purposes;

(b) the provision of credit protection or credit enhancement to any of the parties to the securitization transaction;

(c) the retention of one or more than one securitization position;

(d) the provision of a liquidity facility or similar facility for the securitization transaction;

(e) the repurchase of securitization issues; and

(f) the obligation to acquire any investors' interest in the securitization transaction with an early amortization provision;

"securitization issues", in relation to a securitization transaction, means the securities issued by an issuer in the securitization transaction;

"securitization position", in relation to an AI, means an exposure of the institution to one of the different tranches in a securitization transaction;

"securitization transaction", means a transaction involving the tranching of credit risk associated with a pool of underlying exposures and in respect of which –

(a) there are not less than 2 different tranches;

(b) payments to investors or other parties under the transaction depend on the performance of the underlying exposures; and

(c) the subordination of tranches determines the distribution of losses during the life of the transaction;

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

"short lease", has the meaning assigned to it by the Tenth Schedule of the Company Ordinance (Cap. 32);

"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;

"sovereign" means:

- the Government;
- the central government of a country;
- the central bank of a country;
- an authority of a country which performs in the country functions similar to the functions performed by the HKMA in Hong Kong; or
- a relevant international organisation;

"SPE" means a special purpose entity;

"special purpose entity" means a company, trust, or other entity –

(a) created for a specific purpose;

(b) the activities of which are limited to those appropriate to accomplish that purpose; and

(c) the structure of which is intended to isolate the company, trust or other entity, as the case may be, from the credit risk of an originator or seller of underlying exposures;

"specialized lending" means an AI's exposure to a corporate (often a special purpose vehicle) which has been established specifically to finance or operate a specific asset and has little or no material assets or activities other than owning or operating the specific asset, and therefore has little or no independent capacity to

repay the exposure. Such an exposure should also have the following characteristics, either in legal form or economic substance -

(a) the terms of the exposure give the AI a substantial degree of control over the specific asset and the income which the specific asset generates; and

(b) the primary source of repayment of the exposure is the income generated by the specific asset;

Exposures possessing all the above characteristic should be categorized by the AI as one of the four sub-classes of specialized lending referred to in the Capital Rules;

"specific provisions", in relation to on-balance sheet assets or off-balance sheet exposure of an AI, 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;

"SPM" means the HKMA's Supervisory Policy Manual;

"sponsor", in relation to an asset-backed commercial paper programme or a similar programme with similar features, means a person who establishes the programme and manages, or participates in the management of, the programme by performing one or more than one of the following activities -

(a) approving the sellers to be permitted to participate in the programme;

(b) approving the pool of underlying exposures to be purchased under the programme;

(c) administering the programme, including arranging for the placement into the market of securities issued under the programme; or

(d) providing any credit enhancement or liquidity facility in respect of the programme;

"standardized approach" -

(a) in relation to the calculation of an AI's credit risk for non-securitization exposures, means the method of calculating that risk set out in Part 4 of the Capital Rules;

(b) in relation to the calculation of an AI's operational risk, means the method of calculating that risk set out in Division 2 of Part 7 of the Capital Rules

(c) in relation to the calculation of an AI's market risk, means the method of calculating that risk set out in Part [8] of the Capital Rules;

"standardized approach for securitization", in relation to the calculation of an AI's credit risk for securitization exposures, means the method of calculating that risk set out in Part [9] of the Capital Rules;

"standardized business line" means a business line specified in section 7.2.2(a), (b), (c), (d), (e), (f), (g) or (h) as read with Schedule 7.2.1 of the Capital Rules;

"STC", in relation to the calculation of an AI's credit risk for non-securitization exposures, means the standardized approach;

"STM", in relation to the calculation of an AI's market risk, means the standardized approach;

"STO", in relation to the calculation of an AI's operational risk, means the standardized approach;

"STS" means the standardized approach for securitization;

"supervisory estimate" means the risk-weight in respect of an exposure specified in the Capital Rules or the value of any credit risk component specified in the Capital Rules as an input into a risk-weight function in order to calculate the risk-weight to be allocated to an exposure under IRB;

"supervisory slotting criteria approach" means the IRB calculation approach set out in the Capital Rules which is required by the Rules to be adopted by an AI in respect of its specialized lending for which the AI does not meet the criteria set out in the Rules to enable it to use FIRB or AIRB;

"supplementary capital", in relation to an AI, means the sum, calculated in Hong Kong dollars, of the book value of the institution's capital items specified in the Capital Rules;

"surplus provisions", in relation to an AI, means that part of the excess of the AI's total EP over the AI's total EL amount in respect of its sovereign, bank, corporate and retail exposures which are subject to the IRB Approach that is eligible for inclusion by the AI in its supplementary capital for calculating CAR;

“swap deposit arrangement” means an arrangement entered into by the AI 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;

“synthetic securitization" means a securitization transaction where the credit risk of a pool of underlying exposures is transferred, in whole or in part, through the use of funded or unfunded credit protection that serves to hedge the credit risk of the underlying exposures which remain on the balance sheet of the originator;

“total EL amount” means total expected loss amount;

“total eligible provisions”, in relation to an AI which uses the IRB to calculate its credit risk for non-securitization exposures, mean the sum of the AI’s eligible provisions attributed to corporate, sovereign, bank and retail exposures which are –

(a) subject to the IRB; and

(b) not treated as hedged exposures under the double default framework for recognition of the [credit] risk mitigating effect of guarantees and credit derivative contracts;

“total EP” means total eligible provisions;

“total expected loss amount”, in relation to an AI which uses the IRB to calculate its credit risk for non-securitization exposures, means the sum of the AI’s EL amount attributed to corporate, sovereign, bank and retail exposures which are –

(a) subject to the IRB; and

(b) not treated as hedged exposures under the double default framework for recognition of the [credit] risk mitigating effect of guarantees and credit derivative contracts;

“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 bills” means all purchased bills of exchange by the AI in relation to trade transactions;

“trade-related contingency”[, in relation to an AI] –

(a) means a contingent liability [of the institution] which relates to trade-related obligations; and

(b) includes liabilities [of the institution] arising from issuing and confirming letters of credit, acceptances on trade bills and shipping guarantees;

“trading book”, in relation to an AI, means the institution’s positions in financial instruments and commodities which are held either with the intention of trading in the financial instruments and commodities, or for the purpose of hedging one or more than one of the positions, where

(a) the [positions] are free of any restrictive covenants or are able to be completely hedged; and

(b) the positions are frequently and accurately valued and actively managed;

“traditional securitization" means a securitization transaction where –

(a) a pool of underlying exposures is sold by the originator to a bankruptcy-remote SPE; and

(b) the cash flows from the pool of underlying exposures are used to service payments to investors or other parties under the transaction;

“tranche” means a contractually established segment (“relevant segment”] of the credit risk associated with a pool of underlying exposures in a securitization transaction where –

(a) a position in the relevant segment entails a risk of credit loss greater than, or less than, that of a position of the same amount in each other contractually established segment; and

(b) no account is taken of credit protection provided by third parties directly to the holders of positions in the relevant segment or in other contractually established segments;

“transaction-related contingency”, in relation to an AI -

(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;

“underlying exposures”, in relation to a securitization transaction, means one or more than one on-balance sheet or off-balance sheet exposure in respect of which the credit risk is transferred to one or more than one person by the originator in the securitization transaction;

“undrawn balances” in relation to the calculation of investors’ interest, means the amounts of revolving credit lines that have not been drawn by the obligors of the credit lines, where –

(a) the credit lines have been sold into a securitization transaction; and

(b) the investors remain, in whole or in part, exposed to future drawings by the obligors under the credit lines available to the obligors;

[“unrated”, in relation to an exposure (howsoever described) of an AI, 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 AI, means an agreement in respect of which the following conditions are satisfied -

(a) the agreement is in writing;

(b) the agreement 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) 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) 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) the institution manages the transactions covered by the agreement on a net basis;

(f) the institution maintains in its files documentation adequate to support the netting of the contracts covered by the agreement; and

(g) the agreement 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;]

“value-at-risk”, in relation to a portfolio of exposures, means a measure of the worst expected loss on the portfolio resulting from market movements over a period of time within a given confidence interval;

“VaR” means value-at-risk;

“wrong-way risk” consists of general wrong-way risk and specific wrong-way risk. General wrong-way risk arises when the probability of default of counterparties is positively correlated with general market risk factors.

Specific wrong-way risk arises when the exposure to a particular counterpart is positively correlated with the probability of default of the counterparty due to the nature of the transactions with the counterparty.

1.2.3 Where under these DRs the prior consent of the HKMA is required by an AI in respect of any matter, the institution shall seek the prior consent by making an application in the specified form, if any, to the HKMA.

Part 2

GENERAL REQUIREMENTS

2.1 Application

2.1.1 Subject to the specific exemption for non-listed AIs as prescribed in paragraph 2.1.2, Parts 1 to 3 of these Rules and Parts 4, 5 or 6, as applicable, shall apply to all AIs incorporated in Hong Kong, except in the case of an AI that is a RLB or DTC, where it has:

- total assets of less than HKD1 billion; and
- total customer deposits of less than HKD300 million.

All locally incorporated AIs to which these rules apply shall be known as "Designated Local AIs" for the purposes of these rules.

2.1.2 Rule 3B shall not apply to non-listed Designated Local AIs which are wholly owned subsidiaries of AIs incorporated in Hong Kong.

2.1.3 Subject to the exceptions set out in section 7A.1 of Part 7 of these rules, Parts 1 to 2 and Part 7 shall apply to all overseas incorporated AIs, except those which have a branch or branches in Hong Kong which in total have:

- total assets of less than HKD 10 billion; and
- total customer deposits of less than HKD 2 billion.

All overseas incorporated AIs to which these rules apply shall be known as "Designated Foreign AIs" for the purposes of these rules.

2.1.4 For the purposes of assessing whether a RLB or DTC or an overseas incorporated AI meets the relevant threshold criteria as specified in 2.1.1 and 2.1.3 above, the HKMA will make reference to the figures reported to it under "*Total assets less specific and collective provisions*" and *"Total deposits from customers*" in the "Return of Assets and Liabilities – MA(BS)1" submitted by the Designated AI to the HKMA in respect of each calendar month-end. The average of the relevant figures reported in the twelve months up to and including the fifth month preceding each financial year-end will be adopted for this purpose.

2.1.5 In the event that a Designated Local AI meets the threshold criteria in subsequent financial years it must

nevertheless continue to report in accordance with the standards in these DRs, unless it can demonstrate to the HKMA that it has been substantially and permanently downsized and thus shall no longer be regarded as a Designated Local AI. However, Designated Foreign AIs are not subject to the reporting requirements in these DRs if they satisfy the thresholds set out in 2.1.3 in accordance with the calculation methodology specified in 2.1.4.

2.2 Disclosure Policy

2.2.1 A Designated AI must have a clearly defined disclosure policy in writing approved by the board of directors that addresses the Designated AI's approach to determining the content (including the appropriateness) and frequency of public disclosures and the internal controls over the disclosure process. These internal controls must include a process for verifying/reviewing the accuracy of the disclosures.

2.3 Medium and Location of Disclosure and Issue of Press Release

2.3.1 All Designated AIs are required to publish Disclosure Statements containing the disclosures required under these DRs. A Disclosure Statement can be published either as a stand-alone document or, for Designated Local AIs that are listed in Hong Kong, as an Annex to the AI's annual and interim reports, provided that a clear distinction is made between unaudited and audited information.

2.3.2 A Disclosure Statement must either contain all the disclosures required under these DRs, or provide a summary of the disclosures with complete information being made available on the Designated AI's publicly accessible internet website. A Designated AI must ensure the information included in the summary of the Disclosure Statement is not misleading in any material aspect for the public understanding of the Designated AI's position.

[Additional Guidance - For internet-based disclosures, a Designated AI should make reference to the specimen disclosure templates (<u>Attachments 1 to 3</u>) enclosed with the Guideline on Operation of the Disclosure Rules (at <u>Annex</u>).]

2.3.3 Where, in accordance with paragraph 2.12 below, a Designated Local AI relies on disclosures made by an overseas incorporated parent bank for the purposes of meeting disclosures required under these DRs, its summary of the Disclosure Statement must contain a statement concerning the location of these disclosures and

its Hong Kong website must contain links to the relevant information on its parent bank's website.

2.3.4 A Designated Local AI is also required to issue a Press Release containing either the full Disclosure Statement or a summary of its Disclosure Statement. In the case of a Designated Local AI which is listed in Hong Kong, disclosure requirements under these DRs can be met by the inclusion of either the full Disclosure Statement or a summary of the Disclosure Statement in its annual and interim preliminary results Press Release in both English and Chinese no later than 4 months after the end of each financial year, and 3 months after the end of the interim financial period of that Designated Local AI respectively. The Press Release must indicate the location/website address of the complete Disclosure Statement if it only contains a summary of the Disclosure Statement.

2.3.5 Subject to paragraph 2.3.4 above, a Designated Local AI that is not listed in Hong Kong must issue a Press Release with either the full Disclosure Statement or a summary of the Disclosure Statement in both English and Chinese no later than 4 months after the end of each financial year, and 3 months after the end of each interim financial period of that Designated Local AI respectively. The Press Release must indicate the location/website address of the complete Disclosure Statement if it only contains a summary of the Disclosure Statement.

2.3.6 A Designated Foreign AI must issue a Press Release in both English and Chinese containing either the full Disclosure Statement or a summary of its Disclosure Statement no later than 3 months after the end of each financial period including interim financial period of that Designated Foreign AI. The Press Release must indicate the location/website address of the complete Disclosure Statement if it only contains a summary of the Disclosure Statement.

2.3.7 For the avoidance of doubt, it is not sufficient to issue a press release or advertisement which informs members of the public that a full set of accounts is available at the principal place of business or local branches of the Designated AI without disclosing any of the information specified in these DRs.

2.3.8 A Designated AI must lodge a copy of the Disclosure Statement with a summary of the Disclosure Statement, if applicable, with the HKMA prior to publication of such Statement either on the Designated AI's internet website or via the issue of Press Release. The HKMA will keep

these Disclosure Statements (or summary thereof, as applicable), or Press Release containing such Disclosure Statements (or summary thereof, as applicable), in its public registry maintained under section 20 of the BO.

2.3.9 A copy of either the full Disclosure Statement or summary of the Disclosure Statement, as applicable, must also be made available by the Designated AI for public inspection in the principal place of business of the AI in Hong Kong and, if practicable, in each local branch. The Disclosure Statement (or summary thereof as applicable) must also be made readily available to members of the public on request.

2.4 Interaction with Other Requirements

2.4.1 If a Designated AI makes disclosures under accounting requirements or to satisfy listing requirements promulgated by The Stock Exchange of Hong Kong Limited or information is disclosed through another method (or combination of methods such as a Designated AI's annual report) that is widely available to the public, the Designated AI may rely on that disclosure to fulfil the applicable requirements of these DRs, subject to:

2.4.1.1 the HKMA being satisfied that compliance with the requirements in the DRs is substantially achieved through compliance with the relevant accounting and/or listing requirements or through the other method of disclosure, as the case may be;

2.4.1.2 sufficient explanation is provided on any material differences between the accounting or other disclosure and the ones mandated under the DRs. Such explanation does not have to take the form of a line by line reconciliation; and

2.4.1.3 the inclusion of a statement in the summary of the Disclosure Statement, or the Disclosure Statement, as applicable, concerning the location where all the required information can be found.

[Additional Guidance - These DRs are intended only to supplement, and not to replace or replicate, any of the disclosure requirements under relevant legislation or accounting standards or which are necessary to show a true and fair view of the financial statement of an AI. Where relevant, an AI should comply with such other

disclosure requirements under the Companies Ordinance (Cap. 32), the Rules Governing the Listing of the Securities on The Stock Exchange of Hong Kong Limited, and the Hong Kong Financial Reporting Standards as applicable.]

2.5 Verification

2.5.1 Senior management of a Designated AI must ensure the information that is disclosed is subject to sufficient scrutiny and independent internal review, especially that is not published together with audited financial statements.

[Additional Guidance – No audit of disclosures made under the DRs is required unless otherwise required by accounting or other statutory requirements.]

2.6 Proprietary and Confidential Information

2.6.1 Subject to 2.6.2 and the HKMA's prior consent, a Designated Local AI may be permitted not to disclose certain proprietary or confidential information provided that:

2.6.1.1 general information relating to the subject matter of the disclosure requirements is disclosed; and

2.6.1.2 a statement is included in the AI's Disclosure Statements stating what has been omitted and the reasons for non-disclosure.

2.6.2 In this rule, proprietary or confidential information referred to in 2.6.1 means any information which, if publicly available, would cause serious prejudice to the competitive position of a Designated Local AI.

[Additional Guidance - Proprietary information may include information on products or systems which, if shared with competitors, would render an AI's investments therein less valuable.]

2.6.3 A Designated Local AI must regard information as confidential if there are obligations to customers or other counterparty relationships binding the Designated Local AI to confidentiality.

2.7 Materiality

2.7.1 Subject to 2.7.2 below, the senior management of a Designated AI must ensure disclosures are relevant and all material information is disclosed when complying with the requirements laid down in these DRs.

2.7.2 In this rule, information must be regarded as material in disclosures if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making investment or other economic decisions.

[Additional Guidance - AIs should, at a minimum, also observe:

- *Materiality as defined in both HKAS 1 paragraph 11 and HKAS 8 paragraph 5*[2]*, and a discussion of materiality in paragraphs 29 and 31 of HKAS 1; and*

- *Additional guidance in respect of interpreting materiality in the context of financial statements prepared under HKFRS is set out in HKAS 8 paragraph 41.]*

2.8 Consolidated Group Level Disclosures

2.8.1 Subject to the exceptions set out in 2.8.2 below, the DRs will apply at the top consolidation group level of a Designated Local AI on the basis of consolidation for capital adequacy purposes. Where a Designated Local AI, under section 98(2) of the BO, is required to calculate its CAR on both a solo and a consolidated basis, the Designated Local AI must make disclosures in respect of the consolidation group, unless otherwise required by the DRs or by the HKMA in writing. Disclosures on a solo basis are not required. However, a Designated Local AI may include disclosures on a solo basis along with consolidation group disclosures to enhance users' understanding of the AI's state of affairs.

2.8.2 Exceptions to paragraph 2.8.1 above –

2.8.2.1 Annual financial disclosures set out in 3A.2 to 3A.10, Part 3; and

2.8.2.2 Interim financial disclosures set out in 3B.2 to 3B.4, Part 3;

under which disclosures shall be made based on the separate financial statements presented by the Designated Local AI for accounting purposes;

[2] Both HKAS 1 *Presentation of Financial Statements*, paragraph 11 and HKAS 8 *Accounting Policies, Change in Accounting Estimates and Errors,* paragraph 5 defined "Material" as: Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

2.8.2.3 Annual supplementary disclosures set out in 3A.11(B) to 3A.11(D), Part 3; and

2.8.2.4 Supplementary disclosures under interim financial disclosures set out in 3B.5(B) to 3B.5(D), Part 3;

under which disclosures need only be presented on the basis of consolidated financial statements where consolidated financial statements are presented by the Designated Local AI for accounting purposes; and

2.8.2.5 Liquidity disclosures referred to in 3A.11(E) and 3B.5(E), and corporate governance disclosure referred to in 3A.11(F).

2.9 Basis of Disclosure

2.9.1 A Designated Local AI must make its disclosures on the basis of the specific approach in use for the calculation of regulatory capital requirements for credit risk, market risk and operational risk. Where a Designated Local AI uses a combination of approaches to calculate regulatory capital requirements for the relevant credit risk, market risk or operational risk, as the case may be, the Designated Local AI must make disclosures based on the respective approach in use for each of the exposure classes, and make separate disclosures as applicable.

2.9.2 In the event that a Designated Local AI has employed different approaches for the calculation of regulatory capital requirements referred to in the above paragraph during a single reporting period, the Designated Local AI must make its disclosures on the basis of the approach in use for each of the exposure classes, or portfolio of exposures, as applicable, on the relevant reporting date.

2.10 Comparative Information

2.10.1 Subject to 2.10.2 and the exemptions referred to in 2.10.3 and 2.10.4 below, the corresponding amounts for the immediate preceding financial year must be given for all quantitative disclosures by a Designated Local AI.

2.10.2 For the profit and loss information and liquidity ratio required under Part 3B, the amounts for the corresponding period of the preceding financial year must be given by a Designated Local AI.

2.10.3 Where the DRs were not in effect in respect of the preceding financial year of a Designated Local AI, and it is

impracticable for the AI to apply the disclosure standards set out in these DRs retrospectively, the comparative disclosure referred to in 2.10.1 will not apply for the first year (i.e. no comparative is required).

2.10.4 Where a Designated Local AI adopts different credit risk, market risk or operational risk approaches for the same asset class or portfolio of exposures for two consecutive financial years, the comparative disclosure referred to in 2.10.1 will not apply for the year of change (i.e. no comparative is required). However, the Designated Local AI must state this fact in the Disclosure Statement.

2.10.5 Where there has been a material restatement of prior period amounts, the nature of, and the reason for, the restatement must be disclosed by a Designated Local AI.

2.11 Frequency

2.11.1 For Designated Local AIs, disclosures must be made on an annual basis as prescribed in Part 3, and Part 4, 5 or 6, as applicable, of the DRs, except for Part 3B concerning interim financial disclosures applicable to Designated Local AIs. Subject to the exemption for non-listed Designated Local AIs referred to in paragraph 3.2 in Part 3, Designated Local AIs must make interim financial disclosures for each interim financial period.

[Additional Guidance - The HKMA encourages AIs to disclose risk exposures or any other items that would be prone to rapid changes on a more frequent basis to ensure public understanding of the AI's position.]

2.11.2 Disclosures, in relation to Designated Foreign AIs, must be made on a semi-annual basis.

2.12 Group-Wide Disclosures by Overseas Parent of Designated Local Authorized Institution

2.12.1 If a Designated Local AI is a subsidiary of a bank incorporated overseas, the AI may rely on the disclosures made by the overseas parent in meeting the requirements of the DRs, subject to the Designated Local AI being able to satisfy the HKMA that:

2.12.1.1 the disclosures made by the Designated Local AI's parent bank are not materially different from the disclosures required under the DRs;

2.12.1.2 the disclosures referred to in 2.12.1.1 above are prepared in accordance with the relevant

Basel II principles adopted by the relevant banking supervisory authority of the Designated Local AI's parent bank;

2.12.1.3 the characteristics of the Designated Local AI's risk exposures subject to disclosure requirements under the DRs are not materially different from the risk exposures of the Designated Local AI's parent bank;

2.12.1.4 disclosures by the Designated Local AI's parent bank provide a sufficient level of detail on the range of risks incurred by the Designated AI incorporated in Hong Kong and on how those risks are managed to permit third parties to form a view of the relevant aspects of the Designated Local AI's operations; and

2.12.1.5 the summary of the Disclosure Statement contains a statement of the location where all the required information can be found, and the Designated Local AI's Hong Kong website contains links to the relevant information on the parent bank's website.

2.13 Compliance

2.13.1 All Disclosure Statements issued by a Designated AI covering a semi-annual or annual reporting period beginning on or after the DRs take effect must meet the requirements in these DRs.

[Additional Guidance - For the transitional reporting period which begins prior to but ends after these DRs take effect, AIs should follow the HKMA's SPM on FD-1, FD-2 or FD-3, as applicable, in preparing the Disclosure Statement.]

2.13.2 These DRs are intended as minimum standards. In addition to the disclosures prescribed in these DRs, a Designated AI must also include in its Disclosure Statement:

2.13.2.1 such other information as is necessary to ensure that any information contained in the Disclosure Statement is not misleading in any material aspect; and

2.13.2.2 such other information as is necessary to enable third parties to understand the operations of the AI.

2.13.3 In exceptional circumstances, where a Designated AI is unable to make any of the disclosures required under these DRs, either due to system limitations or due to circumstances beyond its control or due to special circumstances other than for proprietary and confidential reasons, the Disclosure Statement shall:

2.13.3.1 state that fact, and include an explanation of the circumstances which have led to the Designated AI's inability to comply with these DRs; and

2.13.3.2 contain information which is the closest available alternative to that required to be disclosed pursuant to these DRs.

2.13.4 In all such circumstances as described in 2.13.3 the AI must obtain the HKMA's approval in writing before issuing the Disclosure Statement.

[Additional Guidance - The Seventh Schedule of the BO includes adequate disclosure of financial information as one of the criteria for continuing authorization (i.e. criteria that apply to AIs not only at the time of authorization but thereafter) under the Ordinance. Paragraph 11 of that Schedule provides that in relation to an AI incorporated in Hong Kong, the HKMA must be satisfied that it presently discloses, and will continue to disclose, adequate information about the state of its affairs and its income statement in its audited annual accounts and in other parts of its annual report.

Failure to observe the requirements under the DRs may lead to:

- *a breach of the authorization criteria in the Seventh Schedule which would be a ground for revocation of authorization (although the HKMA has the discretion to decide whether to revoke);*

- *other supervisory action that the HKMA considers appropriate according to the circumstances of each case, including but not limited to, requiring the AI by notice in writing under section 52(1)(A) of the BO to rectify any errors or omissions in the AI's Disclosure Statement; and*

- *imposition of a financial penalty in accordance with subsection (4) of section 60A of the BAO.]*

2.14 Statement of Compliance

2.14.1 For annual disclosure, a Designated Local AI must include a statement in its directors' report to the Annual Accounts on the extent of compliance with the DRs and set out in the DRs the reason for any non-compliance.

2.14.2 For interim or half yearly disclosure, a Designated AI must include in its Disclosure Statement a declaration on the extent of compliance with the DRs and the reason for any non-compliance. In the case of Designated Foreign AIs, the declaration must be made by the chief executive of the branch of the Designated Foreign AI in Hong Kong.

2.14.3 In case of full compliance, a general statement in the directors' report or in the Disclosure Statement, as applicable, that a Designated AI complies fully with the disclosure standards set out in these DRs must be made.

2.14.4 In case of partial compliance, the statement in the directors' report or in the Disclosure Statement, as applicable, must specify the areas of, and reasons for, non-compliance.

PART 3

ANNUAL AND INTERIM FINANCIAL DISCLOSURES APPLICABLE TO DESIGNATED LOCAL AIs

3. Application

3.1 Subject to paragraph 3.2 below, this part shall apply to Designated Local AIs as defined in paragraph 2.1.1, Part 2 of the DRs.

3.2 3B of this Part shall not apply to a Designated Local AI which is:

- non-listed; and
- is wholly owned by an AI incorporated in Hong Kong.

3.3 Unless the context requires otherwise, a reference to an AI in this Part is a reference to a Designated Local AI as defined in paragraph 2.1.1, Part 2 of the DRs.

3A ANNUAL FINANCIAL DISCLOSURES

3A.1 Scope of Consolidation

3A.1.1 An AI must disclose the basis of consolidation, including an outline of differences in the basis of consolidation for accounting and regulatory purposes, with a description of the subsidiaries within the group:

3A.1.1.1 That are fully consolidated;

3A.1.1.2 That are deducted from the AI's Capital Base.

3A.1.2 Any restrictions, or other major impediments, on transfer of funds or regulatory capital within the group after taking into account any relevant regulatory, legal or taxation constraints on the transfer of capital.

3A.2 Principal Accounting Policies

3A.2.1 An AI must disclose the principal accounting policies adopted in the preparation of and presentation of its financial statements by way of notes to the accounts. Disclosure of accounting policies must include, but is not limited to the following:

- Accounting policies, practices and methods adopted for credit risk exposures, in particular for loans and advances, which shall include, inter alia, the basis of

measurement at the time of origination and at subsequent periods, recognition of interest income, and the determination of specific provisions, collective provisions and write-offs/charge-offs;

- Accounting treatment of loans and advances upon the repossession of assets where these are material;

- Accounting treatment of related fees and expenses, including whether any incentives relating to residential mortgage loans or other loans and advances have been written off or amortized, where these are material;

- Principal accounting policies adopted for derivatives and off-balance sheet transactions, including an explanation of the accounting practices adopted and major assumptions used for valuation and income recognition. An AI must also specify the policies adopted for offsetting assets and liabilities arising from derivative transactions.

3A.3 Income statement and Equity

3A.3.1 An AI must include the following items of income, expense, gains or losses either in its financial statements or in the notes to the accounts:

- Net gains or net losses on:

  – Financial assets or financial liabilities at fair value through profit or loss, showing separately the amount of net gains or net losses arising from financial assets or financial liabilities: (i) that are designated as such upon initial recognition; and (ii) that are classified as held for trading in accordance with HKAS 39;

  – Available-for-sale financial assets, showing separately the amount of net gains or net losses recognized directly in equity during the financial period and the amount of net gains or net losses removed from equity and recognized in profit or loss for the financial period;

  – Held-to-maturity investments;

  – Loans and receivables; and

  – Financial liabilities measured at amortized cost;

- Net gains or net losses from disposal or revaluation of investment properties;

- Total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not measured at fair value through profit or loss;

- Fee income and expense (other than amounts included in determining the effective interest rate) arising from:

  - Financial assets or financial liabilities that are not measured at fair value through profit or loss; and

  - Trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefits plans, and other institutions;

- Interest income on impaired financial assets accrued in accordance with HKAS 39;

- Dividend income (analysed into receipts from listed and unlisted companies);

- Operating expenses:

  - Staff costs;

  - Premises and equipment expenses, excluding depreciation (analysed where material);

  - Depreciation charges; and

  - Other operating expenses (analysed where material);

- Gains less losses from disposal of property, plant and equipment;

- Impairment losses and specific and collective provisions for impaired assets:

  - Available-for-sale financial assets;

  - Held-to-maturity investments; and

  - Loans and receivables;

- Tax expense (or tax income):

- Hong Kong tax;
- Overseas tax; and
- Deferred tax, if any;

▪ As an appropriation:

- Transfers to or from reserves.

3A.3.2 In relation to tax expense or tax income, the basis on which the Hong Kong profits tax is computed shall be disclosed.

3A.3.3 An AI must disclose any material amount set aside for provisions other than those for depreciation, renewals or diminution in value of assets or any material amount withdrawn from such provisions and not applied for the purposes thereof.

3A.3.4 An AI must disclose in the notes to the accounts the nature and amount of items of income and expense within profit or loss from ordinary activities which are of such size, nature or incidence that their disclosure is necessary for the understanding of the performance of the AI for the financial period concerned.

3A.4 Balance Sheet

3A.4.1 An AI must disclose the carrying amounts of each of the following items, as defined in accordance with HKAS 39, either on the AI's balance sheet or in the notes to the accounts:

(A) Assets

▪ Placements with banks maturing between one and twelve months;

▪ Financial assets measured at fair value through profit or loss, showing separately: (i) those designated as such upon initial recognition; and (ii) those classified as held for trading in accordance with HKAS 39;

▪ Held-to-maturity investments;

▪ Loans and receivables:

- Loans and advances to customers;
- Loans and advances to banks;

- Accrued interest and other accounts (analysed where material);
- Provisions for impaired loans and receivables (analysed between those against loans and advances to customers, loans and advances to banks, accrued interest and other accounts if material):
  - collective provisions; and
  - specific provisions;

- Available-for-sale financial assets;
- Investments in associates;
- Property, plant and equipment; and investment properties (for each major class of assets, the information set out below must be disclosed):
  - Cost or valuation;
  - Additions, revaluations and disposals made during the financial period;
  - Amount provided or written off for depreciation or diminution in value of these assets during the financial period;
  - Accumulated depreciation; and
  - Net book value.

(B) Equity and Liabilities

- Deposits and balances of banks;
- Deposits from customers:
  - Demand deposits and current accounts;
  - Savings deposits; and
  - Time, call and notice deposits;
- Certificates of deposit issued:
  - Measured at fair value through profit or loss, showing separately: (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with HKAS 39; and

- Measured at amortized cost;

- Issued debt securities:
  - Measured at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with HKAS 39; and
  - Measured at amortized cost;
- Deferred taxation, if any (disclosure must be made in accordance with HKAS 12);
- Other liabilities;
- Provisions;
- Loan capital (types, coupon rates and maturities must be disclosed);
- Minority interests;
- Share capital;
- Reserves (analysed into the various material types of reserves, regulatory reserve and other revaluation reserves where maintained).

3A.4.2 An AI must disclose details of the movements in provisions for impaired loans and receivables (including provisions against trade bills where material) during the financial period. The movements in provisions need not be analysed by categories of assets but must be analysed into those in respect of collective and specific provisions. Details of such movements to be disclosed include:

3A.4.2.1 the amount of new provisions charged to the profit and loss in the financial period for losses on impaired loans and advances etc.;

3A.4.2.2 the amount of provisions released back to the profit and loss in the financial period;

3A.4.2.3 the amount of loans and advances etc. written off in the financial period;

3A.4.2.4 amounts recovered in respect of loans and advances etc. written off in previous years;

3A.4.2.5 foreign exchange adjustments in the financial period, if any.

For the purpose of 3A.4.2.1 and 3A.4.2.2, irrespective of the accounting practices of the AI (whether recoveries and write-offs are recorded through the provision for impaired loans and receivables or not), the amount of new provisions must include any amount of loans and advances directly write-off in the financial period and the amount of provisions released back must include any amount of loans and advances recovered directly through the profit or loss in the financial period. The net amount of these two items must be consistent with the amount of provisions reported in the profit and loss statement as shown in 3A.3.1.

3A.4.3 An AI must disclose:

- The amount of impaired loans and advances to customers which are subject to individual assessment for impairment loss;
- The amount of specific provisions made for such loans and advances;
- The percentage of such loans and advances to total loans and advances to customers.

3A.4.4 Similar information as stated in 3A.4.3 above on impaired loans and advances to banks that are subject to individual assessment for impairment loss must be disclosed.

3A.4.5 Where the specific provisions were made after taking into account the value of collateral in respect of such loans and advances, the AI must disclose this fact in order to put the level of provisioning into perspective.

3A.4.6 An AI must analyse investments in securities including treasury bills into equity and debt securities and listed and unlisted securities. The analysis must be provided separately for held-to-maturity securities, available-for-sale securities and securities designated at fair value through profit or loss. The fair value of listed securities must also be disclosed.

3A.4.7 The issuers of held-to-maturity securities, available-for-sale securities and securities designated at fair value through profit or loss must be separately analysed into:

- Sovereign;
- Public sector entities;
- Banks;

- Corporate entities;
- Others.

3A.4.8 An AI must provide the residual contractual maturity breakdown of its assets and liabilities into those that are repayable:

- on demand;
- up to and including 1 month (except those repayable on demand);
- 3 months or less but over 1 month;
- 1 year or less but over 3 months;
- 5 years or less but over 1 year;
- over 5 years; and
- undated.

with an analysis by major types of credit exposure, as set out below:

Assets

- Loans and advances to customers;
- Placements with banks (including loans and advances to banks);
- Certificates of deposit held;
- Debt securities included in:
  - Securities measured at fair value through profit or loss:
    - Trading; and
    - Securities designated at fair value through profit or loss.
  - Available-for-sale securities; and
  - Held-to-maturity securities.

Liabilities

- Deposits and balances of banks;

- Deposits from customers;
- Certificates of deposit issued;
- Issued debt securities;

3A.4.9 The analysis into the relevant maturity groupings must be based on the remaining period to the contractual maturity date as at the balance sheet date.

[Additional Guidance - AIs should refer to the further guidance on maturity classification set out in the Guideline on Operation of the Disclosure Rules (at Annex)].

3A.4.10 For the purpose of 3A.4.1, 3A.4.4 and 3A.4.8, "loans and advances to banks" means placements with banks of greater than one year maturity. "Deposits and balances of banks" means all amounts arising out of banking transactions owned by the AI to other banks; and excludes those balances taking the form of debt securities and certificates of deposits. "Issued debt securities" means all negotiable securities other than loan capital, stocks, shares, import or export trade bills, or certificate of deposits.

3A.4.11 An AI must analyse the gross amount (before accumulated depreciation) of property, plant and equipment, and investment properties included in the financial statements between those included at cost and those included at valuation, if any. For those fixed assets that have been included at valuation, the years in which those assets were valued and the values must be disclosed and in the case of assets that have been valued during the current financial period, the following must be disclosed:

- The names of the persons who valued them and particulars of their qualifications for doing so;
- Bases of valuation used by such persons.

3A.4.12 An AI must disclose how much of the premises which are included in property, plant and equipment, and investment properties are ascribable to those held freehold and those held on a lease (categorized into long lease, medium-term lease and short lease). A distinction must also be made between those held on lease in Hong Kong and those held outside Hong Kong.

3A.4.13 An AI must disclose details of the movements in reserves during the financial period, including the surplus or deficit on revaluation of properties.

(C) Derivatives

3A.4.14 An AI must give a description of its objectives, policies and strategies for the use of derivatives, e.g. the derivative types used for trading and hedging purposes and whether they are exchange-traded or over-the-counter derivatives.

3A.4.15 An AI must disclose the aggregate contractual or notional amounts, credit risk weighted amounts and fair value of derivatives as defined in HKAS 39 analysed by:

- Exchange rate contracts (excluding forward foreign exchange contracts arising from swap deposit arrangements);
- Interest rate contracts; and
- Others.

3A.4.16 In relation to derivatives, the AI must provide an analysis of the aggregate notional amounts, credit risk weighted amounts and fair value of each material class of derivatives instruments. These must include the following, where material:

Exchange rate contracts

- Forwards and futures;
- Swaps;
- Options purchased; and
- Options written.

Interest rate contracts

- Forwards and futures;
- Swaps;
- Options purchased; and
- Options written.

Others – analysed where material.

3A.4.17 An AI must analyse the aggregate notional amounts of each material class of derivatives instruments into those entered into for trading or hedging purposes.

3A.5 Off-Balance Sheet Exposures

3A.5.1 An AI must disclose the contractual or notional amounts of each material class of off-balance sheet financial instruments and analysed where material. At a minimum, these must include the following items:

Contingent liabilities and commitments

- Direct credit substitutes;
- Transaction-related contingencies;
- Trade-related contingencies;
- Note issuance and revolving underwriting facilities;
- Forward asset purchases, amounts owing on partly paid-up shares and securities, forward forward deposits placed, asset sales with recourse;
- Other commitments under which the AI is obliged to provide funds in the future not falling within any of the other categories of off-balance sheet exposures listed above:
  - Commitments with an original maturity of up to and including one year;
  - Commitments with an original maturity of over one year;
  - Commitments which may be cancelled at any time unconditionally by the AI or which provide for automatic cancellation due to a deterioration in a counterparty's creditworthiness;

where "original maturity", in relation to off-balance sheet exposure of an AI, means the period between the date on which the exposure is entered into by the AI and the earliest date on which the AI can, at its option, unconditionally cancel the exposure.

3A.5.2 An AI must also provide such risk exposure information as is necessary for the understanding of the underlying risks of the off-balance sheet exposures incurred by the AI. In particular, the AI must report aggregate credit risk weighted amounts of its contingent liabilities and commitments, if any. The AI must also indicate whether these amounts take into account the effects of valid bilateral netting arrangements.

3A.6 Hedge Accounting

3A.6.1 An AI must disclose the following separately for each type of hedge described in HKAS 39 (i.e. fair value hedges, cash flow hedges, and hedges of net investments in foreign operation):

- A description of each type of hedge;
- A description of the financial instruments designated as hedging instruments and their fair values at the reporting date; and
- The nature of the risks being hedged.

3A.6.2 For cash flow hedges, the AI must disclose:

- the periods when the cash flows are expected to occur and when they are expected to affect profit or loss;
- a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;
- the amount that was recognized in equity during the financial period;
- the amount that was removed from equity and included in profit or loss for the financial period, showing the amount included in each line item in the income statement; and
- the amount that was removed from equity during the financial period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction.

3A.6.3 An AI must disclose separately:

- In fair value hedges, gains or losses:
  - on the hedging instrument; and
  - on the hedged item attributable to the hedged risk;
- the ineffectiveness recognized in profit or loss that arises from cash flow hedges; and
- the ineffectiveness recognized in profit or loss that arises from hedges of net investments in foreign operations.

3A.7 Fair Value

3A.7.1 An AI must disclose the fair value of each class of financial assets and financial liabilities in a way that permits it to be compared with its carrying value in accordance with the requirements of HKFRS 7.

3A.8 Cash Flow Statement

3A.8.1 An AI must disclose a cash flow statement in accordance with HKAS 7.

3A.9 Related Party Transactions

3A.9.1 Where an AI has entered into transactions with related parties, it must disclose the nature of the related party relationship as well as such information about the transactions and outstanding balances as is necessary for an understanding of the potential effects of the relationships on the financial statements of the AI. Such disclosures must be made in accordance with HKAS 24 and include disclosures relating to the AI's policy for lending to related parties.

3A.10 Assets Pledged as Security

3A.10.1 An AI must disclose the aggregate amount of secured liabilities and the nature and carrying values of assets pledged as security.

3A.11 Supplementary Disclosures

3A.11.1 An AI must disclose the following information either as part of the accompanying information to its financial statements or as part of the financial statements themselves.

(A) Capital Structure and Adequacy

Qualitative

3A.11.2 An AI must provide summary information on the terms and conditions of the main features of all capital instruments issued by the AI, especially in the case of innovative, complex or hybrid capital instruments.

Quantitative

3A.11.3 An AI must disclose the components of its total Capital Base as reported under Part II of the Capital Adequacy Return to the HKMA pursuant to the BO. The disclosures must at least include the following items:

3A.11.3.1 Core Capital:

- The AI’s paid-up ordinary share capital;
- The AI’s paid-up irredeemable non-cumulative preference shares;
- The amount standing to the credit of the AI’s share premium account;
- The AI’s published reserves;
- The amount of the AI’s profit and loss account;
- Minority interests in the equity of the AI’s subsidiaries which are included in Core Capital;
- Total deductions from Core Capital.

3A.11.3.2 Supplementary Capital:

- The AI’s reserves/fair value gains on revaluation of holdings of land and buildings;
- The AI’s reserves/fair value gains on revaluation of holdings of securities not held for trading purposes;
- The AI’s fair value gains arising from securities designated at fair value through profit or loss included in Supplementary Capital;
- The amount of the AI’s regulatory reserve for general banking risks;
- The amount of the AI’s collective provisions;
- The amount of the AI’s surplus provisions;
- The AI’s perpetual subordinated debt;
- The AI’s paid-up irredeemable cumulative preference shares;
- The AI’s term subordinated debt;
- The AI’s paid-up term preference shares;

- Minority interests in the equity of the AI's subsidiaries which are not included in Core Capital and minority interests in the paid-up irredeemable cumulative preference shares and paid-up term preference shares of the AI's subsidiaries, which are included in Supplementary Capital.

3A.11.3.3 Deductions from Core Capital and Supplementary Capital.

3A.11.3.4 Total Core Capital after deductions.

3A.11.3.5 Total Supplementary Capital after deductions.

3A.11.3.6 Total Capital Base.

3A.11.4 The aggregate amount of relevant capital shortfall in all subsidiaries not included in the consolidation for regulatory purposes, including the name(s) of such subsidiaries that are excluded. For this purpose, relevant capital shortfall, in relation to a subsidiary of an AI, represents the amount by which that subsidiary is deficient in meeting its minimum capital requirements, and is deducted from the AI's Capital Base in accordance with Part 3 of the Capital Rules.

3A.11.5 An AI must disclose its CAR ratio at balance sheet date, computed in accordance with the Capital Rules. As a supplementary information, the AI must also disclose its "Core Capital Ratio" which is defined as the amount of the AI's Core Capital after making the deductions therefrom required by the Capital Rules to be divided by the AI's total risk-weighted amounts for credit risk, market risk and operational risk as determined in accordance with the Capital Rules. Where an AI is required to compute a consolidated CAR ratio by the HKMA, that consolidated CAR ratio and hence the "Core Capital Ratio" are to be disclosed. Otherwise, the required disclosure must be made on a solo basis.

3A.11.6 Where the AI has earmarked part of its retained earnings for maintaining regulatory reserve to satisfy the provisions of the BO for prudential supervision purposes, the AI must state this fact, including the amount of retained earnings being earmarked for this purpose.

(B) Credit Risk: General Disclosures by Designated Local AIs

Qualitative

3A.11.7 An AI must provide a description of each major business activity that is consistent with its internal management classification. The AI must provide a breakdown of activities expressed in either absolute or percentage terms. If the breakdown is disclosed in absolute terms, the aggregate of such breakdown must be consistent with the figures in the AI's audited income statement. A class of business activities must be reported if it constitutes 10% or more of the total amount in any of the following categories of information:

3A.11.7.1 Total operating income (net of interest expense);

3A.11.7.2 Profit or loss before impairment losses and specific and collective provisions for impaired assets;

3A.11.7.3 Profit or loss after impairment losses and specific and collective provisions for impaired assets;

3A.11.7.4 Profit or loss before taxation.

Quantitative

3A.11.8 For each reported class of business activities referred to in 3A.11.7 above, the AI must report the amount of operating assets as well as provide a breakdown of at least one of the following:

3A.11.8.1 Total operating income (net of interest expense);

3A.11.8.2 Profit or loss before impairment losses and specific and collective provisions for impaired assets;

3A.11.8.3 Profit or loss after impairment losses and specific and collective provisions for impaired assets;

3A.11.8.4 Profit or loss before taxation.

3A.11.9 For the purpose of 3A.11.8, the operating assets of a class of business are those assets that are employed in the course of the operating activities of the business class and

that either are directly attributable to that business class or can be reasonably allocated to that business class.

3A.11.10 An AI must report concentrations of the following items arising from or booked in major countries or geographical segments. A country or geographical segment must be reported where it contributes 10% or more of the relevant disclosure item. The information to be disclosed must include:

3A.11.10.1 Total operating income (net of interest expense);

3A.11.10.2 Profit or loss before taxation;

3A.11.10.3 Total assets;

3A.11.10.4 Total liabilities;

3A.11.10.5 Contingent liabilities and commitments.

3A.11.11 An AI must report the above information based on the location of the principal operations of the subsidiary or, in the case of the AI itself, on the location of the branch responsible for reporting the results or booking the assets. The AI must state clearly the basis adopted for such reporting.

[Additional Guidance – the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) on segment reporting.]

3A.11.12 An AI must disclose a breakdown of its fees and commission income by such major product lines as credit lines, corporate advisory, investment management and trustee services, guarantees and indemnities. The AI must report a product line if it constitutes 10% or more of the total fees and commission income of the AI.

3A.11.13 An AI must disclose the breakdown of its cross-border claims by major countries or geographical segments according to the location of the counterparties and by the types of counterparties (analysed into banks, public sector entities and others). The basis of the country or geographical classification must be stated, including the fact that transfer of risk has been taken into account. Any country or geographical segment that constitutes 10% or more of an AI's aggregate cross-border claims after taking into account any risk transfers must be reported. Risk transfer may only be recognized if the claims are guaranteed by a party in a country which is different from

that of the counterparty or if the claims are on an overseas branch of a bank whose head office is located in another country.

3A.11.14 Cross-border claims must include the following types of financial claims:

3A.11.14.1 receivables and loans and advances;

3A.11.14.2 balances due from banks;

3A.11.14.3 holdings of certificates of deposit, bills, promissory notes, commercial paper, other debt instruments and investments;

3A.11.14.4 accrued interest and overdue interest on the above assets.

For the avoidance of doubt, claims arising between branches and subsidiaries of the AI must be excluded.

[Additional Guidance – the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) for further guidance on the disclosure of cross-border claims.]

3A.11.15 An AI must disclose the breakdown of the gross amount of loans and advances to customers by major countries or geographical segments according to the location of the counterparties. Any country or geographical segment that constitutes 10% or more of the aggregate amount of loans and advances to customers after taking into account any risk transfer must be reported.

3A.11.16 An AI must disclose the breakdown of the gross amount of loans and advances to customers by major industry sectors. To achieve consistency of reporting among AIs, the information must be disclosed in accordance with the industry categories set out in this paragraph.

[Additional Guidance – the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) for further guidance on the types of loans and advances that should be included in the respective categories as well as how the disclosures should be reported.]

- **Loans and advances for use in Hong Kong**

  (a) Industrial, commercial and financial:

  - Property development;
  - Property investment;

- Financial concerns;
- Stockbrokers;
- Wholesale and retail trade;
- Manufacturing;
- Transport and transport equipment;
- Recreational activities;
- Information technology; and
- Others.

(b) Individuals:

- Loans for the purchase of flats in the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme;
- Loans for the purchase of other residential properties;
- Credit card advances; and
- Others.

▪ **Trade finance**

▪ **Loans and advances for use outside Hong Kong**

3A.11.17 Additional credit risk information for the items referred to in 3A.11.16 above such as the extent to which these loans and advances are backed by collateral or other security must also be disclosed.

[Additional Guidance – the items referred to in 3A.11.16 above should be broken down into more detailed sub-categories, as applicable. The aggregate of the breakdown should be consistent with the relevant figures in the AI's balance sheet.]

3A.11.18 An AI must disclose the following by major industry or counterparty type. The AI must report the industry or counterparty if it constitutes 10% of more of the aggregate amount of loans and advances.

▪ Amount of impaired loans and advances which are subject to individual assessment for impairment loss

and if available, overdue loans and advances, provided separately;

- Specific provisions and collective provisions; and
- Amount of new provisions charged to the profit and loss, and the amount of impaired loans and advances charge-offs during the financial period.

[Additional Guidance – For the purpose of 3A.11.18, the AI should follow the accounting disclosure requirements in determining the industry or counterparty type for disclosure.]

3A.11.19 An AI must disclose the amount of impaired loans and advances which are subject to individual assessment for impairment loss and, if available, overdue loans and advances provided separately broken down by major countries or geographical segments including, if practical, the amounts of specific provisions and collective provisions related to each geographical area where the portion of collective provision that is not allocated to a geographical segment must be disclosed separately. A major country or geographical segment is one that constitutes 10% or more of the aggregate amount of loans and advances to customers after taking into account any risk transfer.

3A.11.20 An AI must disclose the gross amount of loans and advances (to customers and banks) which have been overdue for:

- 6 months or less but over 3 months;
- 1 year or less but over 6 months; and
- over 1 year.

Both the absolute amount of overdue loans and advances to customers and the percentage of such loans and advances to total loans and advances to customers must be given for each maturity bucket. Total loans and advances to customers must correspond to the total of loans and advances for use in Hong Kong, trade finance, and loans and advances for use outside Hong Kong as disclosed in 3A.11.16 above. Similar information on overdue loans and advances to banks must also be disclosed.

3A.11.21 An AI must provide a description of collateral held against the overdue loans and advances as security and other

credit enhancements and, unless impracticable, an estimate of their fair value. It must also disclose the amount of specific provisions made on such overdue loans and advances.

3A.11.22 An AI must disclose the amount of rescheduled loans and advances to customers, net of those that have been overdue for over 3 months and reported in paragraph 3A.11.20, and the percentage of such loans and advances to total loans and advances to customers. Similar information on rescheduled loans and advances to banks must be given.

3A.11.23 An AI must disclose the amount of other assets, analysed by major categories of assets such as trade bills and debt securities, which have been overdue for:

- 6 months or less but over 3 months;
- 1 year or less but over 6 months; and
- over 1 year.

[Additional Guidance – For the purpose of 3A.11.18 to 3A.11.23 above, the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) for further guidance on the classification and definition of overdue and rescheduled assets and how to disclose the value of collateral held against overdue loans and advances.]

3A.11.24 An AI must disclose the amount of repossessed assets held, irrespective of the accounting treatment of the related loans and advances, upon the repossession of the assets.

(C) Non-bank Mainland Exposures

3A.11.25 An AI must analyse the aggregate non-bank Mainland exposures to non-bank counterparties where such exposures are material.

[Additional Guidance – the AI should refer to the counterparties categories and the type of exposures as provided in the Guideline on Operation of the Disclosure Rules (at Annex) for the disclosure of non-bank Mainland exposures.]

(D) Currency Risk

3A.11.26 An AI must disclose foreign currency exposures arising from trading, non-trading and structural positions. The position in a particular foreign currency must be reported if the net position (in absolute terms) constitutes 10% or more of the AI's total net position in all foreign currencies. The financial information to be disclosed in respect of each such currency must include:

- Spot assets;
- Spot liabilities;
- Forward purchases;
- Forward sales;
- Net options position; and
- Net long (short) position.

An AI may calculate its net options position using either the Delta Equivalent Approach set out in the return "Foreign Currency Position" or the AI's internal reporting method provided that the basis of calculation is clearly stated.

3A.11.27 An AI must also report its net structural position (assets less liabilities) in a particular foreign currency (in absolute terms) if it constitutes 10% or more of the AI's total net structural position in all foreign currencies.

[Additional Guidance – the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) for further guidance on the disclosure of currency risk.]

(E) Liquidity

3A.11.28 An AI must disclose its average liquidity ratio for the financial period (i.e. normally 12 months). The average ratio must be the simple average of each calendar month's average liquidity ratio as reported by the AI to the HKMA pursuant to the BO. Subject to the HKMA's prior agreement, an AI may include overseas branches and / or subsidiaries in the calculation of its liquidity ratio.

(F) Corporate Governance

3A.11.29 An AI must disclose the roles, functions and composition of any key specialised committees established under its Board of Directors. Typical specialised committees include the Executive Committee, Credit Committee, Asset and Liability Committee and Audit Committee.

3A.11.30 An AI must include a statement on the extent of its compliance with the guideline in SPM CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" issued by the HKMA and the reason and details of any non-compliance.

3B INTERIM FINANCIAL DISCLOSURES

3B.1 Scope of Consolidation

3B.1.1 An AI must disclose the basis of consolidation including an outline of differences in the basis of consolidation for accounting and regulatory purposes, with a description of the subsidiaries within the group:

3B.1.1.1 That are fully consolidated;

3B.1.1.2 That are deducted from the AI's Capital Base.

3B.1.2 Any restrictions, or other major impediments, on transfer of funds or regulatory capital within the group after taking into account any relevant regulatory, legal or taxation constraints on the transfer of capital.

3B.2 Income Statement and Equity

3B.2.1 An AI must include the following items of income, expense, gains or losses either in its financial statements or in the notes to the accounts:

- Net gains or net losses on:
  - Financial assets or financial liabilities at fair value through profit or loss, showing separately the amount of net gains or net losses arising from financial assets or financial liabilities: (i) that are designated as such upon initial recognition; and (ii) that are classified as held for trading in accordance with HKAS 39;

  - Available-for-sale financial assets, showing separately the amount of net gains or losses recognized directly in equity during the interim financial period and the amount removed from equity and recognized in profit or loss for the interim financial period;

  - Held-to-maturity investments;

  - Loans and receivables; and

  - Financial liabilities measured at amortized cost;

- Net gains or net losses from disposal or revaluation of investment properties;

- Total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss;

- Fee income and expense (other than amounts included in determining the effective interest rate) arising from:

  - Financial assets or financial liabilities that are not measured at fair value through profit or loss; and

  - Trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefits plans, and other institutions;

- Interest income on impaired financial assets accrued in accordance with HKAS 39;

- Dividend income (analysed into receipts from listed and unlisted companies);

- Operating expenses:

  - Staff costs;

  - Premises and equipment expenses, excluding depreciation (analysed where material);

  - Depreciation charges; and

  - Other operating expenses (analysed where material);

- Gains less losses from disposal of property, plant and equipment;
- Impairment losses and specific and collective provisions for impaired assets:
  - Available-for-sale financial assets;
  - Held-to-maturity investments; and
  - Loans and receivables;
- Tax expense (or tax income):
  - Hong Kong tax;
  - Overseas tax; and
  - Deferred tax, if any;
- As an appropriation:
  - Transfers to or from reserves.

3B.2.2 An AI must provide an explanatory statement relating to the activities of the AI and profit (or loss) during the interim financial period which must include any significant information that their disclosure is necessary for an informed assessment of the trend of the activities and profit (or loss) of the AI together with an indication of any special factor which has influenced those activities and the profit (or loss) during the interim financial period concerned. The statement must enable a comparison to be made with the corresponding period of the preceding financial year.

3B.2.3 An AI must disclose in the notes to the accounts the nature and amount of items of income and expense within profit or loss from ordinary activities which are of such size, nature or incidence that their disclosure is necessary for the understanding of the performance of the AI for the interim financial period concerned.

3B.3 Balance Sheet

3B.3.1 An AI must disclose the carrying amounts of each of the following items, as defined in accordance with HKAS 39, either on the AI's balance sheet or in the notes to the accounts:

(A) Assets

- Placements with banks maturing between one and twelve months;

- Financial assets measured at fair value through profit or loss, showing separately: (i) those designated as such upon initial recognition; and (ii) those classified as held for trading in accordance with HKAS 39;

- Held-to-maturity investments;

- Loans and receivables:

  - Loans and advances to customers;

  - Loans and advances to banks;

  - Accrued interest and other accounts (analysed where material);

  - Provisions for impaired loans and receivables (analysed between those against loans and advances to customers, loans and advances to banks, accrued interest and other accounts if material):

    - collective provisions; and

    - specific provisions;

- Available-for-sale financial assets;

- Investments in associates;

- Property, plant and equipment; and investment properties (for each major class of assets, the information set out below must be disclosed):

  - Cost or valuation;

  - Additions, revaluations and disposals made during the interim financial period;

  - Amount provided or written off for depreciation or diminution in value of these assets during the interim financial period;

  - Accumulated depreciation; and

  - Net book value.

(B) Equity and Liabilities

- Deposits and balances of banks;
- Deposits from customers:
  - Demand deposits and current accounts;
  - Savings deposits; and
  - Time, call and notice deposits;
- Certificates of deposit issued:
  - Measured at fair value through profit or loss, showing separately: (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with HKAS 39; and
  - Measured at amortized cost;
- Issued debt securities:
  - Measured at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with HKAS 39; and
  - Measured at amortized cost;
- Deferred taxation, if any (disclosed in accordance with HKAS 12);
- Other liabilities;
- Provisions;
- Loan capital (types, coupon rates and maturities must be disclosed);
- Minority interests;
- Share capital;
- Reserves (analysed into the various material types of reserves, regulatory reserve and other revaluation reserves where maintained).

3B.3.2 An AI must disclose:

- The amount of impaired loans and advances to customers which are subject to individual assessment for impairment loss;
- The amount of specific provisions made for such loans and advances;
- The percentage of such loans and advances to total loans and advances to customers.

3B.3.3 Similar information as stated in 3B.3.2 above on impaired loans and advances to banks that are subject to individual assessment for impairment loss must be disclosed.

3B.3.4 For the purpose of 3B.3.1 and 3B.3.3, "loans and advances to banks" means placements with banks of greater than one year maturity. "Deposits and balances of banks" means all amounts arising out of banking transactions owned by the AI to other banks; and excludes those balances taking the form of debt securities and certificates of deposits. "Issued debt securities" means all negotiable securities other than loan capital, stocks, shares, import or export trade bills, or certificate of deposits.

3B.3.5 Where the specific provisions were made after taking into account the value of collateral in respect of such loans and advances, the AI must disclose this fact in order to put the level of provisioning into perspective.

(C) Derivatives

3B.3.6 An AI must disclose the aggregate contractual or notional amounts of derivatives as defined in HKAS 39 analysed by:

- Exchange rate contracts (excluding forward foreign exchange contracts arising from swap deposit arrangements);
- Interest rate contracts; and
- Others.

3B.3.7 An AI must also provide such risk exposure information as is necessary for the understanding of the underlying risks of the exposures incurred by the AI through the use of derivative instruments. In particular, the AI must report aggregate credit risk weighted amounts and aggregate fair value of its exchange rate contracts, interest rate contracts

and other derivatives, if any. The AI must also indicate whether these amounts take into account the effects of valid bilateral netting arrangements.

3B.4 Off-Balance Sheet Exposures

3B.4.1 An AI must disclose the contractual or notional amounts of each material class of off-balance sheet financial instruments and analysed where material. At a minimum, these must include the following items:

Contingent liabilities and commitments

- Direct credit substitutes;
- Transaction-related contingencies;
- Trade-related contingencies;
- Note issuance and revolving underwriting facilities;
- Forward asset purchases, amounts owing on partly paid-up shares and securities, forward forward deposits placed, asset sales with recourse;
- Other commitments under which the AI is obliged to provide funds in the future not falling within any of the other categories of off-balance sheet exposures listed above:
  - Commitments with an original maturity of up to and including one year;
  - Commitments with an original maturity of over one year;
  - Commitments which may be cancelled at any time unconditionally by the AI or which provide for automatic cancellation due to a deterioration in a counterparty's creditworthiness;

  where "original maturity", in relation to off-balance sheet exposure of an AI, means the period between the date on which the exposure is entered into by the AI and the earliest date on which the AI can, at its option, unconditionally cancel the exposure.

3B.4.2 An AI must also provide such risk exposure information as is necessary for the understanding of the underlying risks of the off-balance sheet exposures incurred by the AI. In particular, the AI must report aggregate credit risk weighted amounts of its contingent liabilities and

commitments, if any. The AI must also indicate whether these amounts take into account the effects of valid bilateral netting arrangements.

3B.5 Supplementary Disclosures

3B.5.1 An AI must disclose the following information either as part of the accompanying information to their financial statements or as part of the financial statements themselves.

(A) Capital Structure and Adequacy

3B.5.2 An AI must disclose the components of its total Capital Base as reported under Part II of the Capital Adequacy Return to the HKMA pursuant to the BO. The disclosures must at least include the following items:

3B.5.2.1 Core Capital:

- The AI's paid-up ordinary share capital;
- The AI's paid-up irredeemable non-cumulative preference shares;
- The amount standing to the credit of the AI's share premium account;
- The AI's published reserves;
- The amount of the AI's profit and loss account;
- Minority interests in the equity of the AI's subsidiaries which are included in Core Capital;
- Total deductions from Core Capital.

3B.5.2.2 Supplementary Capital:

- The AI's reserves/fair value gains on revaluation of holdings of land and buildings;
- The AI's reserves/fair value gains on revaluation of holdings of securities not held for trading purposes;
- The AI's fair value gains arising from securities designated at fair value through

profit or loss included in Supplementary Capital;

- The amount of the AI's regulatory reserve for general banking risks;
- The amount of the AI's collective provisions;
- The amount of the AI's surplus provisions;
- The AI's perpetual subordinated debt;
- The AI's paid-up irredeemable cumulative preference shares;
- The AI's term subordinated debt;
- The AI's paid-up term preference shares;
- Minority interests in the equity of the AI's subsidiaries which are not included in Core Capital and minority interests in the paid-up irredeemable cumulative preference shares and paid-up term preference shares of the AI's subsidiaries, which are included in Supplementary Capital.

3B.5.2.3 Deductions from Core Capital and Supplementary Capital.

3B.5.2.4 Total Core Capital after deductions.

3B.5.2.5 Total Supplementary Capital after deductions.

3B.5.2.6 Total Capital Base.

3B.5.3 The aggregate amount of relevant capital shortfall in all subsidiaries not included in the consolidation for regulatory purposes, including the name(s) of such subsidiaries that are excluded. For this purpose, relevant capital shortfall, in relation to a subsidiary of an AI, represents the amount by which that subsidiary is deficient in meeting its minimum capital requirements, and is deducted from the AI's Capital Base in accordance with Part 3 of the Capital Rules.

3B.5.4 The AI must disclose its CAR ratio at balance sheet date, computed in accordance with the Capital Rules. As a supplementary information, the AI must also disclose its "Core Capital Ratio" which is defined as the amount of the

AI’s Core Capital after making the deductions therefrom required by the Capital Rules to be divided by the AI’s total risk-weighted amounts for credit risk, market risk and operational risk as determined in accordance with the Capital Rules. Where an AI is required to compute a consolidated CAR ratio by the HKMA, that consolidated CAR ratio and hence the “Core Capital Ratio” are to be disclosed. Otherwise, the required disclosure must be made on a solo ratio.

3B.5.5 Where the AI has earmarked part of its retained earnings for maintaining regulatory reserve to satisfy the provisions of the BO for prudential supervision purposes, the AI must state this fact, including the amount of retained earnings being earmarked for this purpose.

(B) Credit Risk: General Disclosures by Designated Local AIs

3B.5.6 An AI must disclose the breakdown of its cross-border claims by major countries or geographical segments according to the location of the counterparties and by the types of counterparties (analysed into banks, public sector entities and others). The basis of the country or geographical classification must be stated, including the fact that transfer of risk has been taken into account. Any country or geographical segment that constitutes 10% or more of an AI’s aggregate cross-border claims after taking into account any risk transfer must be reported. Risk transfer may only be recognized if the claims are guaranteed by a party in a country which is different from that of the counterparty or if the claims are on an overseas branch of a bank whose head office is located in another country.

3B.5.7 Cross-border claims must include the following types of financial claims:

3B.5.7.1 receivables and loans and advances;

3B.5.7.2 balances due from banks;

3B.5.7.3 holdings of certificates of deposit, bills, promissory notes, commercial paper, other debt instruments and investments;

3B.5.7.4 accrued interest and overdue interest on the above assets.

For the avoidance of doubt, claims arising between branches and subsidiaries of the AI must be excluded.

[Additional Guidance – the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) for further guidance on the disclosure of cross-border claims.]

3B.5.8 An AI must disclose the breakdown of the gross amount of loans and advances to customers by major countries or geographical segments according to the location of the counterparties. Any country or geographical segment that constitutes 10% or more of the aggregate amount of loans and advances to customers after taking into account any risk transfer must be reported.

3B.5.9 An AI must disclose the breakdown of the gross amount of loans and advances to customers by major industry sectors. To achieve consistency of reporting among AIs, the information must be disclosed in accordance with the industry categories set out in this paragraph.

[Additional Guidance – the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) for further guidance on the types of loans and advances that should be included in the respective categories as well as how the disclosures should be reported.]

- **Loans and advances for use in Hong Kong**

  (a) Industrial, commercial and financial:

  - Property development;
  - Property investment;
  - Financial concerns;
  - Stockbrokers;
  - Wholesale and retail trade;
  - Manufacturing;
  - Transport and transport equipment;
  - Recreational activities;
  - Information technology; and
  - Others.

  (b) Individuals:

  - Loans for the purchase of flats in the Home Ownership Scheme, Private Sector

Participation Scheme and Tenants Purchase Scheme;

- Loans for the purchase of other residential properties;
- Credit card advances; and
- Others.

▪ **Trade finance**

▪ **Loans and advances for use outside Hong Kong**

3B.5.10 Additional credit risk information for the items referred to in 3B.5.9 above such as the extent to which these loans and advances are backed by collateral or other security must also be disclosed.

[Additional Guidance – the items referred to in 3B.5.9 above should be broken down into more detailed sub-categories, as applicable. The aggregate of the breakdown should be consistent with the relevant figures in the AI's balance sheet.]

3B.5.11 An AI must disclose the following by major industry or counterparty type. The AI must report the industry or counterparty if it constitutes 10% of more of the aggregate amount of loans and advances.

▪ Amount of impaired loans and advances which are subject to individual assessment of impairment loss and if available, overdue loans and advances, provided separately;

▪ Specific provisions and collective provisions; and

▪ Amount of new provisions charged to the profit and loss, and the amount of impaired loans and advances charge-offs during the interim financial period.

[Additional Guidance – For the purpose of 3B.5.11, the AI should follow the accounting disclosure requirements in determining the industry or counterparty type for disclosure.]

3B.5.12 An AI must disclose the amount of impaired loans and advances which are subject to individual assessment for impairment loss and, if available, overdue loans and advances provided separately broken down by major countries or geographical segments including, if practical, the amounts of specific provisions and collective

provisions related to each geographical segment where the portion of collective provision that is not allocated to a geographical segment must be disclosed separately. A major country or geographical segment is one that constitutes 10% or more of the aggregate amount of loans and advances to customers after taking into account any risk transfer.

3B.5.13 An AI must disclose the gross amount of loans and advances (to customers and banks) which have been overdue for:

- 6 months or less but over 3 months;
- 1 year or less but over 6 months; and
- over 1 year.

Both the absolute amount of overdue loans and advances to customers and the percentage of such loans and advances to total loans and advances to customers must be given for each maturity bucket. Total loans and advances to customers must correspond to the total of loans and advances for use in Hong Kong, trade finance and loans and advances for use outside Hong Kong as disclosed in 3B.5.9 above. Similar information on overdue loans and advances to banks must also be disclosed.

3B.5.14 An AI must provide a description of collateral held against the overdue loans and advances as security and other credit enhancements and, unless impracticable, an estimate of their fair value. It must also disclose the amount of specific provisions made on such overdue loans and advances.

3B.5.15 An AI must disclose the amount of rescheduled loans and advances to customers, net of those that have been overdue for over 3 months and reported in paragraph 3B.5.13 and the percentage of such loans and advances to total loans and advances to customers. Similar information on rescheduled loans and advances to banks must be given.

3B.5.16 An AI must disclose the amount of other assets, analysed by major categories of assets such as trade bills and debt securities, which have been overdue for:

- 6 months or less but over 3 months;
- 1 year or less but over 6 months; and
- over 1 year.

[Additional Guidance – For the purpose of 3B.5.11 to 3B.5.16 above, the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) for further guidance on the classification and definition of overdue and rescheduled assets and how to disclose the value of collateral held against overdue loans and advances.]

3B.5.17 An AI must disclose the amount of repossessed assets held, irrespective of the accounting treatment of the related loans and advances, upon the repossession of the assets.

(C) Non-bank Mainland Exposures

3B.5.18 An AI must analyse the aggregate non-bank Mainland exposures to non-bank counterparties where such exposures are material.

[Additional Guidance – the AI should refer to the counterparties categories and the type of exposures as provided in the Guideline on Operation of the Disclosure Rules (at Annex) for the disclosure of non-bank Mainland exposures.]

(D) Currency Risk

3B.5.19 An AI must disclose foreign currency exposures arising from trading, non-trading and structural positions. The position in a particular foreign currency must be reported if the net position (in absolute terms) constitutes 10% or more of the AI's total net position in all foreign currencies. The financial information to be disclosed in respect of each such currency must include:

- Spot assets;
- Spot liabilities;
- Forward purchases;
- Forward sales;
- Net options position; and
- Net long (short) position.

An AI may calculate its net options position using either the Delta Equivalent Approach set out in the return "Foreign Currency Position" or the AI's internal reporting method provided that the basis of calculation is clearly stated.

3B.5.20 An AI must also report its net structural position (assets less liabilities) in a particular foreign currency (in absolute terms) if it constitutes 10% or more of the AI's total net structural position in all foreign currencies.

[Additional Guidance – the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) for further guidance on the disclosure of currency risk.]

(E) Liquidity

3B.5.21 An AI must disclose its average liquidity ratio for the interim financial period. The average ratio must be the simple average of each calendar month's average liquidity ratio as reported by the AI to the HKMA pursuant to the BO. Subject to the HKMA's prior agreement, an AI may include overseas branches and / or subsidiaries in the calculation of its liquidity ratio.

PART 4

ADDITIONAL ANNUAL DISCLOSURES SPECIFIC TO DESIGNATED LOCAL AIs USING THE BASIC APPROACH TO CALCULATION OF CREDIT RISK

4.1 Application

4.1.1 This part shall apply to an AI that:

- is a "Designated Local AI" as defined in paragraph 2.1.1, Part 2 of the DRs; and
- has been approved by the HKMA to adopt the BSA Approach to calculate its regulatory capital requirements for credit risk.

4.1.2 Unless the context requires otherwise, a reference to an AI in this Part is a reference to a Designated Local AI which uses the BSA Approach to calculate its regulatory capital requirements for credit risk and is subject to Part 4.

4.2 Capital Adequacy

4.2.1 An AI subject to Part 4 must make the following disclosures:

Qualitative

4.2.2 Summary discussion of the AI's approach to assessing the adequacy of its capital to support current and future activities.

Quantitative

4.2.3 The AI's regulatory capital requirements for credit risk.

4.2.4 Subject to 4.4.2 below, the AI's regulatory capital requirements for market risk calculated according to the specific approach in use by the AI:

4.2.4.1 The STM Approach;

4.2.4.2 The IMA - trading book;

4.2.4.3 Any other approach that has the prior consent of the HKMA.

4.2.5 The AI's regulatory capital requirements for operational risk calculated according to the specific approach in use by the AI:

4.2.5.1 The BIA Approach;

4.2.5.2 The ASA Approach;

4.2.5.3 The STO Approach.

4.3 General Qualitative Disclosures

4.3.1 An AI subject to Part 4 must provide a description of the main types of risk arising from its business, including but not limited to credit, liquidity, interest rate, foreign exchange and market risks arising from its trading book. The description must cover the policies, procedures and controls used for identifying, measuring, monitoring and controlling those risks and for managing the capital required to support them. At a minimum, this must include a discussion of:

4.3.1.1 Title or position of the board and senior management members that oversee risk management, set strategy and policy for each type of risk, and the means of ensuring it is implemented;

[Additional Guidance – the AI should include the role of the specialized board committees in reviewing the adequacy of risk management policies and systems; and the extent to which these are effectively operating.]

4.3.1.2 Method(s) used to identify and measure the various forms of risk;

[Additional Guidance – Taking credit risk as an example, the AI should provide descriptions of the analytical techniques for assessing the risk profile and structure of the credit portfolio and identifying credit risk concentrations, and the use of internal credit risk rating systems.]

4.3.1.3 Details relating to the approval of transactions including the delegation of credit authority, and the approval process for new products and activities;

4.3.1.4 Method(s) used to monitor and control risks;

[Additional Guidance – Taking credit risk as an example, the AI should describe the structure of the AI's credit risk management function, the segregation of duties in key credit functions, the use of independent risk control units and the use of credit risk mitigation techniques such as collateral, netting, guarantees and credit derivative contracts.]

4.3.1.5 Method(s) of using limits for controlling risks;

[Additional Guidance - For example e.g. limits on large exposures and credit risk concentrations.]

4.3.1.6 Details of operational controls;

4.3.1.7 The role of internal audit.

4.4 Market Risk

4.4.1 An AI subject to Part 4 must make the following disclosures:

4.4.2 Where an AI makes use of the de minimis exemption for market risk as specified in the Capital Rules, the AI must state the fact that it has relied on this exemption, and no further disclosures are required.

4.4.3 Except for those cases falling within rule 4.4.2, an AI must make both qualitative and quantitative disclosures in accordance with the specific approach to the calculation of market risk adopted by the AI.

4.4.4 Disclosures required from an AI using the STM Approach:

Qualitative

4.4.4.1 Disclose portfolios of exposures covered by the STM Approach.

Quantitative

4.4.4.2 The AI's regulatory capital requirements for:

- Interest rate exposures;
- Equity position exposures;
- Foreign exchange exposures;
- Commodities exposures.

4.4.5 Disclosures required from an AI using the IMA to calculate its exposure to market risk in respect of its trading book:

Qualitative

4.4.5.1 Disclose portfolios of exposures covered by the IMA, and provide a discussion of the extent of and methodologies for the AI's compliance with the "Prudent valuation guidance" for positions held in the trading book in accordance with the HKMA's Guidance on [Market Risk Management]. The discussion must include an articulation of the soundness standards on which the AI's internal capital adequacy assessment is based. It must also include a description of the methodologies used to achieve a capital adequacy assessment that is consistent with the soundness standards.

[Additional Guidance – the HKMA's Guidance on [Market Risk Management] is to be forthcoming.]

4.4.5.2 For each portfolio of exposures covered by the IMA, the AI must disclose:

- The characteristics of the model(s) used;
- A description of the stress testing applied by the AI to the portfolio;
- A description of the approach used for backtesting / validating the accuracy and consistency of the internal models and modelling processes.

Quantitative

4.4.5.3 For exposures in the AI's trading book under the IMA, the AI must disclose:

- The high, mean, and low VaR values over the reporting period and the VaR at period-end;
- A comparison of VaR estimates with actual gains / losses experienced by the AI, with an analysis of important "outliers" in backtest results.

4.4.6 Disclosures required from an AI using any other approach that has the prior consent of the HKMA for calculation of market risk in respect of its trading book:

Qualitative

4.4.6.1 The AI must provide similar information as required in 4.4.5.1 to 4.4.5.2 above.

4.4.6.2 Where applicable, the HKMA may specify other disclosures which the HKMA considers necessary for the understanding of the AI's underlying market risk exposures.

Quantitative

4.4.6.3 The AI must provide similar information as required in 4.4.5.3 above.

4.4.6.4 Where applicable, the HKMA may specify other disclosures which the HKMA considers necessary for the understanding of the AI's underlying market risk exposures.

PART 5

ADDITIONAL ANNUAL DISCLOSURES SPECIFIC TO DESIGNATED LOCAL AIs USING THE STANDARDIZED APPROACH TO CALCULATION OF CREDIT RISK

5.1 Application

5.1.1 This part shall apply to an AI that:

- is a "Designated Local AI" as defined in paragraph 2.1.1, Part 2 of the DRs; and
- uses the STC Approach to calculate its regulatory capital requirements for credit risk.

5.1.2 This part shall also apply to exempted non-securitization exposures under the IRB Approaches and exempted securitization exposure under the IRBS Approach to the calculation of regulatory capital requirements for credit risk as detailed in paragraph 6.1.2, Part 6 of the DRs.

5.1.3 Unless the context requires otherwise, a reference to an AI in this Part is a reference to a Designated Local AI which:

- uses the STC Approach to the calculation of regulatory capital requirements for credit risk; or
- uses the STC Approach to the calculation of regulatory capital requirements for credit risk for exempted non-securitization exposures under the IRB Approaches and exempted securitization exposures under the IRBS Approach;

and is subject to Part 5.

5.2 Capital Adequacy

5.2.1 An AI subject to Part 5 must make the following disclosures:

<u>Qualitative</u>

5.2.2 Summary discussion of the AI's approach to assessing the adequacy of its capital to support current and future activities.

Quantitative

5.2.3 The AI's regulatory capital requirements for credit risk disclosed separately for each portfolio of exposures.

5.2.4 The AI's regulatory capital requirements for securitization exposures.

5.2.5 Subject to 5.8.2, the AI's regulatory capital requirements for market risk calculated according to the specific approach in use by the AI:

5.2.5.1 The STM Approach;

5.2.5.2 The IMA – trading book;

5.2.5.3 Any other approach that has the prior consent of the HKMA.

5.2.6 The AI's regulatory capital requirements for operational risk calculated according to the specific approach in use by the AI:

5.2.6.1 The BIA Approach;

5.2.6.2 The ASA Approach;

5.2.6.3 The STO Approach.

5.3 General Qualitative Disclosures

5.3.1 An AI subject to Part 5 must provide a description of the main types of risk arising from its business, including the risks referred to under sections 5.4 to 5.11 below. The description must cover the policies, procedures and controls used for identifying, measuring, monitoring and controlling those risks and for managing the capital required to support them. At a minimum, this must include a discussion of:

5.3.1.1 Title or position of the board and senior management members that oversee risk management, set strategy and policy for each type of risk, and the means of ensuring it is implemented;

[Additional Guidance – the AI should include the role of the specialized board committees in reviewing the adequacy of risk management policies and systems; and the extent to which these are effectively operating.]

5.3.1.2 Method(s) used to identify and measure the various forms of risk;

[Additional Guidance – Taking credit risk as an example, the AI should provide descriptions of the analytical techniques for assessing the risk profile and structure of the credit portfolio and identifying credit risk concentrations, and the use of internal credit risk rating systems.]

5.3.1.3 Details relating to the approval of transactions including the delegation of credit authority, and the approval process for new products and activities;

5.3.1.4 Method(s) used to monitor and control risks;

[Additional Guidance – Taking credit risk as an example, the AI should describe the structure of the AI's credit risk management function, the segregation of duties in key credit functions, the use of independent risk control units and the use of credit risk mitigation techniques such as collateral, netting, guarantees and credit derivative contracts.]

5.3.1.5 Method(s) of using limits for controlling risks;

[Additional Guidance - For example e.g. limits on large exposures and credit risk concentrations.]

5.3.1.6 Details of operational controls;

5.3.1.7 The role of internal audit.

5.4 Credit Risk: Specific Disclosures

5.4.1 An AI subject to Part 5 must make the following disclosures:

<u>Qualitative</u>

5.4.2 Names of ECAIs and ECAs used, plus reasons for any changes since the last reporting period;

5.4.3 Types of exposure for which each agency is used;

5.4.4 A description of the process used to map EACI issuer rating or EACI issue specific rating, as the case may be, to on-balance sheet assets and off-balance sheet exposures in the AI's banking book.

Quantitative

5.4.5 For each separately disclosed portfolio of exposures, the aggregate amount of exposures (i.e. principal amount or credit equivalent amount, as applicable, net of specific provisions) covered by the STC Approach.

5.4.6 For each separately disclosed portfolio of exposures after recognized credit risk mitigation covered by the STC Approach, the AI must disclose the aggregate amount of outstanding exposures after recognized credit risk mitigation, distinguishing between rated and unrated exposures, and the respective risk-weighted amounts.

5.4.7 The amount of exposures that are deducted from the AI's Capital Base.

[Additional Guidance – For the purpose of 5.4.5 to 5.4.7 above, the AI should make reference to the specimen disclosure template (Attachment 4) enclosed with the Guideline on Operation of the Disclosure Rules (at Annex).]

5.5 General Disclosures for Counterparty Credit Risk-related Exposures

5.5.1 An AI subject to Part 5 must make the following disclosures:

Qualitative

5.5.2 The general qualitative disclosures with respect to counterparty credit risk arising from over-the-counter derivative transactions, repo-style transactions and credit derivative contracts other than recognized credit derivative contracts, booked in banking book or trading book, including a discussion of:

5.5.2.1 Methodology used to assign internal capital and credit limits for counterparty credit exposures;

[Additional Guidance – the AI should follow the HKMA's framework of the supervisory review process ("SRP") under Pillar 2, including internal capital adequacy assessment process ("CAAP") in assessing and managing capital needs. The framework and supervisory standards of SRP are to be forthcoming.]

5.5.2.2 Policies for securing collateral and establishing credit reserves;

5.5.2.3 Policies with respect to wrong-way risk exposures;

5.5.2.4 The impact of the amount of collateral the AI would have to provide given a credit rating downgrade of the AI.

<u>Quantitative</u>

5.5.3 For the over-the-counter derivative transactions, repo-style transactions and credit derivative contracts other than recognized credit derivative contracts as covered in 5.5.2 above, the AI must disclose the respective gross aggregate positive fair value of contracts, credit equivalent amounts or counterparty exposure for the case of repo-style transactions, after taking into account the effect of valid bilateral netting arrangement, recognized collateral held by the AI (including type, e.g. cash, government securities, etc.), net credit exposures and the respective risk-weighted amounts. The disclosure must also include the notional amounts of credit derivative hedges, and the distribution of the AI's net credit exposures and risk-weighted amounts by types of credit exposure (e.g. exchange rate contracts, interest rate contracts).

5.5.4 The notional amounts of credit derivative contracts that create exposures to counterparty credit risk, segregated between use for the AI's own credit portfolio, and use in the AI's intermediation activities, including the distribution of the credit derivative contracts used (e.g. credit default swaps, total return swaps), broken down further by protection bought and sold within each type of contract.

5.5.5 For the purpose of 5.5.2 and 5.5.3, repo-style transactions refer to those transactions falling within section [4.4.6(3) or 4.4.6(4)(a)] of Part 4 of the Capital Rules.

5.6 Credit Risk Mitigation

5.6.1 An AI subject to Part 5 must make the following disclosures for credit risk mitigation other than those in relation to over-the-counter derivative transactions, repo-style transactions and credit derivatives contracts other than recognized credit derivatives contracts, booked in banking book or trading book, which are already covered in 5.5 above:

<u>Qualitative</u>

5.6.2 The general qualitative disclosures with respect to credit risk mitigation including:

5.6.2.1 Policies and processes for, and an indication of the extent to which the AI makes use of, on- and off-balance sheet recognized netting;

5.6.2.2 Policies and processes for collateral valuation and management;

5.6.2.3 A description of the main types of recognized collateral taken by the AI;

5.6.2.4 The main types of guarantor / credit derivative counterparty and their creditworthiness for the recognized guarantees and credit derivative contracts;

5.6.2.5 Information about (market or credit) risk concentrations within the credit risk mitigation taken.

<u>Quantitative</u>

5.6.3 For each separately disclosed portfolio of exposures under the STC Approach, the total exposure (after, where applicable, on- or off-balance sheet recognized netting) that is covered by recognized collateral after the application of haircuts required by the Capital Rules.

5.6.4 For each separately disclosed portfolio of exposures under the STC Approach, the total exposure (after, where applicable, on- or off-balance sheet recognized netting) that is covered by recognized guarantees / credit derivative contracts after the application of haircuts required by the Capital Rules.

5.6.5 For the purpose of 5.6, credit derivative contracts that are treated as part of synthetic securitization transactions must be excluded from disclosures in this section and included in the disclosures under 5.7 below.

5.7 Asset Securitization

5.7.1 An AI subject to Part 5 must make the following disclosures:

<u>Qualitative</u>

5.7.2 The general qualitative disclosures with respect to securitization (including synthetic securitization transactions) including a discussion of:

5.7.2.1 The AI's objectives in relation to securitization activities, including the extent to which these

activities transfer credit risk in respect of the underlying exposures of the securitization transaction away from the AI to other entities;

5.7.2.2 The roles played by the AI in the securitization process and an indication of the extent of the AI's involvement in each of them;

5.7.2.3 The regulatory capital approaches that the AI follows for its securitization activities.

5.7.3 Summary of the AI's accounting policies for securitization activities, including:

5.7.3.1 Whether the transactions are treated as sales or financings;

5.7.3.2 Recognition of gain-on-sale;

5.7.3.3 Key assumptions for valuing retained interests, including any significant changes since the last reporting period and the impact of such changes;

5.7.3.4 Treatment of synthetic securitizations if this is not covered by other accounting policies (e.g. on derivatives);

5.7.3.5 Names of ECAIs used for securitizations and the types of securitization exposure for which each agency is used.

Quantitative

5.7.4 The total outstanding exposures securitized by the AI and subject to the securitization framework set out in Part [9] of the Capital Rules (broken down into traditional securitization and synthetic securitization), by exposure type. Securitization transactions in which the originating AI does not retain any securitization exposure must be shown separately but need only be reported for the year of inception. An AI must differentiate between exposures resulting from activities in which it acts only as sponsor, and exposures that result from all other securitization activities of the AI that are subject to the securitization framework set out in Part [9] of the Capital Rules.

5.7.5 For exposures securitized by the AI and subject to the securitization framework set out in Part [9] of the Capital Rules:

5.7.5.1 Amount of impaired / overdue assets securitized;

5.7.5.2 Losses recognized by the AI during the current reporting period;

broken down by exposure type.

5.7.6 Aggregate amount of securitization exposures retained or purchased broken down by exposure type.

5.7.7 Aggregate amount of securitization exposures retained or purchased, the risk-weighted amounts and the associated regulatory capital requirements by STS Approach for these exposures. Exposures that have been deducted entirely from Core Capital, credit-enhancing I/Os and other exposures deducted from Core Capital and Supplementary Capital, as the case may be, must be disclosed separately by type of underlying asset.

5.7.8 For securitizations subject to early amortization provisions, the following items by underlying asset type for securitized facilities:

5.7.8.1 The aggregate drawn exposures attributed to the originator's and investors' interests;

5.7.8.2 The aggregate regulatory capital requirements by STS Approach, incurred by the AI against its retained (i.e. the originator's) shares of the drawn balances and undrawn balances;

5.7.8.3 The aggregate regulatory capital requirements by STS Approach, incurred by the AI against the investors' interest in shares of drawn balances and undrawn balances.

5.7.9 Summary of AI's current year's securitization activity, including the amount of exposures securitized (by exposure type), and recognized gain or loss on sale by exposure type.

5.8 Market Risk

5.8.1 An AI subject to Part 5 must make the following disclosures:

5.8.2 Where the AI makes use of the de minimis exemption for market risk as specified in the Capital Rules, the AI must state the fact that it has relied on this exemption, and no further disclosures are required.

5.8.3 Except for those cases falling within section 5.8.2, the AI must make both qualitative and quantitative disclosures in accordance with the specific approach to the calculation of market risk adopted by the AI.

5.8.4 Disclosures required from an AI using the STM Approach:

Qualitative

5.8.4.1 Disclose portfolios of exposures covered by the STM Approach.

Quantitative

5.8.4.2 The AI's regulatory capital requirements for:

- Interest rate exposures;
- Equity position exposures;
- Foreign exchange exposures;
- Commodities exposures.

5.8.5 Disclosures required from an AI using the IMA to calculate its exposure to market risk in respect of its trading book:

Qualitative

5.8.5.1 Disclose portfolios of exposures covered by the IMA, and provide a discussion of the extent of and methodologies for the AI's compliance with the "Prudent valuation guidance" for positions held in the trading book in accordance with the HKMA's Guidance on [Market Risk Management]. The discussion must include an articulation of the soundness standards on which the AI's internal capital adequacy assessment is based. It must also include a description of the methodologies used to achieve a capital adequacy assessment that is consistent with the soundness standards.

[Additional Guidance – the HKMA's Guidance on [Market Risk Management] is to be forthcoming.]

5.8.5.2 For each portfolio of exposures covered by the IMA, the AI must disclose:

- The characteristics of the model(s) used;

- A description of the stress testing applied by the AI to the portfolio;
- A description of the approach used for backtesting / validating the accuracy and consistency of the internal models and modelling processes.

Quantitative

5.8.5.3 For exposures in the AI's trading book under the IMA, the AI must disclose:

- The high, mean, and low VaR values over the reporting period and the VaR at period-end;
- A comparison of VaR estimates with actual gains / losses experienced by the AI, with an analysis of important "outliers" in backtest results.

5.8.6 Disclosures required from an AI using any other approach that has the prior consent of the HKMA for calculation of market risk in respect of its trading book:

Qualitative

5.8.6.1 The AI must provide similar information as required in 5.8.5.1 to 5.8.5.2 above.

5.8.6.2 Where applicable, the HKMA may specify other disclosures which the HKMA considers necessary for the understanding of the AI's underlying market risk exposures.

Quantitative

5.8.6.3 The AI must provide similar information as required in 5.8.5.3 above.

5.8.6.4 Where applicable, the HKMA may specify other disclosures which the HKMA considers necessary for the understanding of the AI's underlying market risk exposures.

5.9 Operational Risk

5.9.1 An AI subject to Part 5 must make the following disclosures:

Qualitative

5.9.2 Disclose the approach(es) for operational risk capital assessment for which the AI uses to calculate its exposure to operational risk for each standardized business line. AI using the BIA Approach must disclose the fact.

5.10 Equities: Disclosures for Banking Book Positions

5.10.1 An AI subject to Part 5 must make the following disclosures:

Qualitative

5.10.2 The general qualitative disclosures with respect to equity risk including:

5.10.2.1 Differentiation between holdings on which capital gains are expected and those taken under other objectives including for relationship and strategic reasons;

5.10.2.2 Discussion of important policies covering the valuation and accounting of equity holdings in the AI's banking book. This includes the accounting techniques and valuation methodologies used by the AI, including key assumptions and practices affecting valuation as well as significant changes in these practices in the reporting period.

Quantitative

5.10.3 The cumulative realized gains or losses arising from sales and liquidations of the equity holdings in the reporting period.

5.10.4 Total unrealized gains or losses recognized in the AI's reserves but not through the profit and loss account, and any of these amounts included in the AI's Supplementary Capital for CAR purposes.

5.10.5 The AI's regulatory capital requirements broken down by equity groupings which is consistent with the AI's internal methodology, and the aggregate amounts and the type of equity investments subject to any supervisory transition or grandfathering provisions regarding regulatory capital requirements.

5.11 Interest Rate Risk in the Banking Book

5.11.1 An AI subject to Part 5 must make the following disclosures:

Qualitative

5.11.2 The general qualitative disclosures with respect to IRRBB, including the nature of IRRBB and key assumptions used by the AI in its measurement of IRRBB, including assumptions regarding loan prepayments and behaviour of non-maturity deposits where non-maturity deposit is a deposit without a fixed maturity, and frequency of IRRBB measurement.

Quantitative

5.11.3 The variations in earnings or economic value (or relevant measure used by the AI) for upward and downward interest rate shocks according to the AI's method for measuring IRRBB, broken down by currency (as relevant).

PART 6

ADDITIONAL ANNUAL DISCLOSURES SPECIFIC TO DESIGNATED LOCAL AIs USING THE FOUNDATION OR ADVANCED INTERNAL RATINGS-BASED APPROACH TO CALCULATION OF CREDIT RISK

6.1 Application

6.1.1 Subject to the exception prescribed in paragraph 6.1.2, this part shall apply to an AI that

- is a "Designated Local AI" as defined in paragraph 2.1.1, Part 2 of the DRs; and
- has been approved by the HKMA to adopt either the FIRB or AIRB Approach to calculate its regulatory capital requirements for credit risk.

6.1.2 This part does not apply to exposures or portfolios of exposures that have been exempted from the IRB Approaches for non-securitization exposures and the IRBS Approach for securitization exposures under the Capital Rules. Disclosures relating to these exposures or portfolios must be made according to the rules set out in Part 5 of the DRs.

6.1.3 Unless the context requires otherwise, a reference to an AI in this Part is a reference to a Designated Local AI which uses either the FIRB or AIRB Approach to the calculation of regulatory capital requirements for credit risk and is subject to Part 6.

6.2 Capital Adequacy

6.2.1 An AI subject to Part 6 must make the following disclosures:

<u>Qualitative</u>

6.2.2 Summary discussion of the AI's approach to assessing the adequacy of its capital to support current and future activities.

<u>Quantitative</u>

6.2.3 The AI's regulatory capital requirements disclosed separately for each portfolio under the FIRB Approach and for each portfolio under the AIRB Approach covering:

- Corporate (including SME Corporates, specialized lending exposures, and purchased corporate receivables), sovereign and bank;
- Residential mortgages;
- Qualifying revolving retail exposures;
- Other retail exposures to individuals and small business retail exposures; and
- Other exposures including cash items and other on-balance sheet assets that are not categorized as corporate, sovereign, bank, retail and equity exposures and cash items.

The AI must distinguish between qualifying revolving retail exposures and other retail exposures to individuals and small business retail exposures unless these portfolios are insignificant in size relative to overall credit exposures and the risk profile is sufficiently similar that separate disclosure would not help understanding of the risk profile of the AI's retail businesses.

6.2.4 The AI's regulatory capital requirements for securitization exposures.

6.2.5 The AI's regulatory capital requirements for equity exposures held in the banking book under the IRB:

6.2.5.1 Equity portfolios subject to the market-based approach:

- Equity portfolios subject to the simple risk weight method;
- Equity portfolios in the banking book subject to the internal models method.

6.2.5.2 Equity portfolios subject to the PD / LGD approach.

6.2.6 The AI's regulatory capital requirements for market risk calculated according to the specific approach in use by the AI:

6.2.6.1 The STM Approach;

6.2.6.2 The IMA – trading book;

6.2.6.3 Any other approach that has the prior consent of the HKMA.

6.2.7 The AI's regulatory capital requirements for operational risk calculated according to the specific approach in use by the AI:

6.2.7.1 The BIA Approach;

6.2.7.2 The ASA Approach;

6.2.7.3 The STO Approach.

6.3 General Qualitative Disclosures

6.3.1 An AI subject to Part 6 must provide a description of the main types of risk arising from their business, including the risks referred to under sections 6.4 to 6.12 below. The description must cover the policies, procedures and controls used for identifying, measuring, monitoring and controlling those risks and for managing the capital required to support them. At a minimum, this must include a discussion of:

6.3.1.1 Title or position of the board and senior management members that oversee risk management, set strategy and policy for each type of risk, and the means of ensuring it is implemented;

[Additional Guidance – the AI should include the role of the specialized board committees in reviewing the adequacy of risk management policies and systems; and the extent to which these are effectively operating.]

6.3.1.2 Method(s) used to identify and measure the various forms of risk;

[Additional Guidance – Taking credit risk as an example, the AI should provide descriptions of the analytical techniques for assessing the risk profile and structure of the credit portfolio and identifying credit risk concentrations, and the use of internal credit risk rating systems.]

6.3.1.3 Details relating to the approval of transactions including the delegation of credit authority, and the approval process for new products and activities;

6.3.1.4 Method(s) used to monitor and control risks;

[Additional Guidance – Taking credit risk as an example, the AI should describe the structure

of the AI's credit risk management function, the segregation of duties in key credit functions, the use of independent risk control units and the use of credit risk mitigation techniques such as collateral, netting, guarantees and credit derivative contracts.]

6.3.1.5 Method(s) of using limits for controlling risks;

[Additional Guidance - For example e.g. limits on large exposures and credit risk concentrations.]

6.3.1.6 Details of operational controls;

6.3.1.7 The role of internal audit.

6.4 Credit Risk: Disclosures for Portfolios subject to Supervisory Estimates in the IRB

6.4.1 An AI subject to Part 6 must make the following disclosures:

Quantitative

6.4.2 For exposures subject to the supervisory estimates under IRB (including any specialized lending products subject to the supervisory slotting criteria approach and equities under the simple risk weight method), the AI must disclose the aggregate outstanding amounts in each risk-weight.

6.5 Credit Risk: Specific Disclosures

6.5.1 An AI subject to Part 6 must make the following disclosures:

Qualitative

6.5.2 If the AI has not fully adopted either the FIRB Approach or the AIRB Approach and subject to section 6.1.2 above, a description of the nature of exposures within each portfolio of exposures that are subject to the following requirements:

6.5.2.1 The FIRB Approach;

6.5.2.2 The AIRB Approach.

6.5.3 The AI must give an explanation and review of the:

6.5.3.1 Structure of its internal rating systems and the relationship between internal and external ratings;

6.5.3.2 Use of internal estimates by the AI other than for calculation of the AI's regulatory capital requirement under the IRB;

6.5.3.3 Process for managing and recognizing credit risk mitigation;

6.5.3.4 Control mechanisms for the rating system including discussion of independence and accountability of the rating process, and rating systems review.

6.5.4 The AI must give a description of its internal ratings process, provided separately for the following five distinct portfolios:

6.5.4.1 Corporate (including SME Corporates, specialized lending exposures, and purchased corporate receivables), sovereign and bank;

6.5.4.2 Equities where the AI uses the PD/LGD approach for equities held in its banking book;

6.5.4.3 Residential mortgages;

6.5.4.4 Qualifying revolving retail exposures;

6.5.4.5 Other retail exposures to individuals and small business retail exposures.

The AI must distinguish between qualifying revolving retail exposures and other retail exposures to individuals and small business retail exposures unless these portfolios are insignificant in size relative to overall credit exposures and the risk profile is sufficiently similar that separate disclosure would not help understanding of the risk profile of the AI's retail businesses.

For each portfolio, the description must include:

6.5.4.6 The types of exposure included in the portfolio;

6.5.4.7 For corporate, sovereign, bank and equities exposures referred to in 6.5.4.1 and 6.5.4.2, a description of the definitions of the variables, methods and data for estimation and validation of PD, LGD and EAD, including assumptions employed in the derivation of these variables except for LGD and EAD related disclosures that do not apply to AIs adopting the FIRB Approach and equities exposures;

6.5.4.8 For retail exposures referred to in 6.5.4.3 to 6.5.4.5, the AI must report the definitions of the variables, methods and data for estimation and validation of PD, LGD and EAD, including assumptions employed in the derivation of these variables. The AI must also distinguish between the qualifying revolving retail exposures and other retail exposures to individuals and small business retail exposures unless these portfolios are insignificant in size relative to overall credit exposures and the risk profile of each portfolio is sufficiently similar that no separate disclosure would not jeopardize the understanding of the risk profile of the AI's retail businesses;

6.5.4.9 A description of permitted deviations from the IRB reference definition of default as specified in Part [6] of the Capital Rules where determined by the AI to be material, including the broad segments of the portfolio(s) affected by such deviations[3].

6.5.5 The AI must provide a description of the approaches it has followed for determining specific provisions and collective provisions and the statistical methods it has used.

Quantitative: Risk Assessment

6.5.6 For each portfolio, the AI must disclose the amount of exposures (including both the amount drawn down and EAD on undrawn commitments) subject to:

6.5.6.1 The FIRB Approach;

6.5.6.2 The AIRB Approach.

6.5.7 For each portfolio except retail exposures referred to in 6.5.4.3 to 6.5.4.5, the AI must present the following information across a sufficient number of obligor grades (including defaulted obligor grade) as the AI considers necessary for a consistent, logical and cogent differentiation of the underlying credit risk for:

6.5.7.1 Total exposures (for corporate, sovereign and bank counterparties: amount of outstanding

[3] An AI only needs to describe the main areas where there has been material divergence from the reference definition of default such that it would affect the readers' ability to compare and understand the disclosure of exposures by obligor grade.

loans and EAD on undrawn commitments either on a stand-alone basis or on a combined basis; for equities: outstanding amount of equities exposures);

6.5.7.2 For AI adopting the AIRB Approach: exposure-weighted average LGD in percentage;

6.5.7.3 Exposure weighted-average risk-weight.

The PD, LGD and EAD disclosures must take into account the effects of recognized collateral, netting and guarantees/credit derivatives. Disclosure of each obligor grade must include the exposure weighted-average PD for each grade. Where an AI is aggregating obligor grades for the purposes of disclosure, this must represent such a breakdown of the distribution of obligor grades used in the IRB Approach that provides for a consistent, logical and cogent differentiation of the underlying credit risk.

6.5.8 The AI adopting the AIRB Approach must disclose the amount of undrawn commitments and exposure-weighted average EAD for each portfolio of exposures. The AI only needs to provide one estimate of EAD for each portfolio. However, the AI may also disclose EAD estimates across a number of EAD categories, against the related amount of undrawn commitments;

6.5.9 For each retail portfolio referred to in 6.5.4.3 to 6.5.4.5, the AI must either disclose[4]:

6.5.9.1 On a pool basis in accordance with rule 6.5.7 (i.e. the same approach as for non-retail portfolios); or

6.5.9.2 An analysis of exposures (outstanding loans and EAD on commitments) on a pool basis against a sufficient number of EL grades that provides for a consistent, logical and cogent differentiation of the underlying credit risk.

Quantitative: Historical Results

6.5.10 The AI must disclose the actual losses (e.g. charge-offs and specific provisions) in the reporting period for each

[4] An AI would normally be expected to follow the disclosures provided for the non-retail portfolios. However, the AI may choose to adopt EL grades as the basis of disclosure to permit understanding and differentiation of the underlying credit risk. Where the AI is aggregating internal grades (either PD / LGD or EL) for the purposes of disclosure, this must represent such a breakdown of the distribution of those grades used in the IRB Approach that provides for a consistent, logical and cogent differentiation of the underlying credit risk.

portfolio (as defined in 6.5.4.1 to 6.5.4.5 above) and how this differs from past experience, together with an explanation for the factors that affected the loss experienced in the preceding period.

6.5.11 The AI must disclose the estimates against actual outcomes over a sufficiently long period to permit understanding of the reliability of the information provided by the AI in the quantitative risk assessment disclosures in 6.5.6 to 6.5.9 above over the long run. At a minimum, this must include information on estimates of losses against actual losses in each portfolio over a period as long run as possible to allow for the assessment of the AI's performance of the internal rating processes for each portfolio. Where appropriate, the AI must further decompose this to provide analysis of PD and, for the AI on the AIRB Approach, LGD and EAD outcomes against estimates provided in the quantitative risk assessment disclosures in 6.5.6 to 6.5.9 above. The AI must provide this information where there are material differences between the PD, LGD or EAD estimates given by the AI compared to actual outcomes over the long run. The AI must also provide explanations for such differences. For the purpose of this section, "long run" means a time period that captures a reasonable mix of high-default and low-default years of an economic cycle.

6.6 General Disclosures for Counterparty Credit Risk-related Exposures

6.6.1 An AI subject to Part 6 must make the following disclosures:

<u>Qualitative</u>

6.6.2 The general qualitative disclosures with respect to counterparty credit risk arising from over-the-counter derivative transactions, repo-style transactions and credit derivative contracts other than recognized credit derivative contracts, booked in banking book or trading book, including a discussion of:

6.6.2.1 Methodology used to assign internal capital and credit limits for counterparty credit exposures;

[Additional Guidance – the AI should follow the HKMA's framework of the supervisory review process ("SRP") under Pillar 2, including internal capital adequacy assessment process ("CAAP") in assessing and managing capital

needs. The framework and supervisory standards of SRP are to be forthcoming.]

6.6.2.2 Policies for securing collateral and establishing credit reserves;

6.6.2.3 Policies with respect to wrong-way risk exposures;

6.6.2.4 The impact of the amount of collateral the AI would have to provide given a credit rating downgrade of the AI.

Quantitative

6.6.3 The AI must provide the distribution of major types of credit exposures by counterparty type.

6.6.4 For the over-the-counter derivative transactions, repo-style transactions and credit derivative contracts other than recognized credit derivative contracts as covered in 6.6.2 above, the AI must disclose the respective gross aggregate positive fair value of contracts, credit equivalent amounts or counterparty exposure for the case of repo-style transactions, after taking into account the effect of valid bilateral netting arrangement, recognized collateral held by the AI (including type, e.g. cash, government securities, etc.), and the respective risk-weighted amounts. The disclosure must also include the notional amounts of credit derivative hedges, and the distribution of the AI's EAD and risk-weighted amounts by types of credit exposure (e.g. exchange rate contracts, interest rate contracts).

6.6.5 The notional amounts of credit derivative contracts that create exposures to counterparty credit risk, segregated between use for the AI's own credit portfolio, and use in the AI's intermediation activities, including the distribution of the credit derivative contracts used (e.g. credit default swaps, total return swaps), broken down further by protection bought and sold within each type of contract.

6.6.6 For the purpose of 6.6.2 to 6.6.4, repo-style transactions refer to those transactions falling within section [4.4.6(3) or 4.4.6(4)(a)] of Part 4 of the Capital Rules.

6.7 Credit Risk Mitigation

6.7.1 An AI subject to Part 6 must make the following disclosures for credit risk mitigation other than those in

relation to over-the-counter derivative transactions, repo-style transactions and credit derivative contracts other than recognized credit derivative contracts, booked in banking book or trading book, which are already covered in 6.6 above:

Qualitative

6.7.2 The general qualitative disclosures with respect to credit risk mitigation including:

6.7.2.1 Policies and processes for, and an indication of the extent to which the AI makes use of, on- and off-balance sheet recognized netting;

6.7.2.2 Policies and processes for collateral valuation and management;

6.7.2.3 A description of the main types of recognized collateral taken by the AI;

6.7.2.4 The main types of guarantor / credit derivative counterparty and their creditworthiness for the recognized guarantees and credit derivative contracts;

6.7.2.5 Information about (market or credit) risk concentrations within the credit risk mitigation taken.

Quantitative

6.7.3 For each separately disclosed credit risk portfolio under the FIRB Approach, the total exposure (after, where applicable, on- or off-balance sheet recognized netting) that is covered by recognized collateral after the application of haircuts required by the Capital Rules.

6.7.4 For each separately disclosed credit risk portfolio under the FIRB or AIRB Approach, the total exposure (after, where applicable, on- or off-balance sheet recognized netting) that is covered by recognized guarantees / credit derivative contracts after the application of haircuts required by the Capital Rules.

6.7.5 For the purpose of 6.7, credit derivative contracts that are treated as part of synthetic securitization transactions must be excluded from disclosures in this section but included in the disclosures under 6.8 below.

6.8 Asset Securitization

6.8.1 An AI subject to Part 6 must make the following disclosures:

<u>Qualitative</u>

6.8.2 The general qualitative disclosures with respect to securitization (including synthetics securitization transactions) including a discussion of:

6.8.2.1 The AI's objectives in relation to securitization activities, including the extent to which these activities transfer credit risk in respect of the underlying exposures of the securitization transaction away from the AI to other entities;

6.8.2.2 The roles played by the AI in the securitization process and an indication of the extent of AI's involvement in each of them;

6.8.2.3 The regulatory capital approaches that the AI follows for its securitization activities.

6.8.3 Summary of the AI's accounting policies for securitization activities, including:

6.8.3.1 Whether the transactions are treated as sales or financings;

6.8.3.2 Recognition of gain-on-sale;

6.8.3.3 Key assumptions for valuing retained interests, including any significant changes since the last reporting period and the impact of such changes;

6.8.3.4 Treatment of synthetic securitizations if this is not covered by other accounting policies (e.g. on derivatives);

6.8.3.5 Name of ECAIs used for securitizations and the types of securitization exposure for which each agency is used.

Quantitative

6.8.4 The total outstanding exposures securitized by the AI and subject to the securitization framework set out in Part [9] of the Capital Rules (broken down into traditional securitization and synthetic securitization), by exposure type. Securitization transactions in which the originating AI does not retain any securitization exposure must be shown separately but need only be reported for the year of inception. An AI must differentiate between exposures resulting from activities in which it acts only as sponsor, and exposures that result from all other securitization activities of the AI that are subject to the securitization framework set out in Part [9] of the Capital Rules.

6.8.5 For exposures securitized by the AI and subject to the securitization framework set out in Part [9] of the Capital Rules:

6.8.5.1 Amount of impaired / overdue assets securitized;

6.8.5.2 Losses recognized by the AI during the current reporting period

broken down by exposure type.

6.8.6 Aggregate amount of securitization exposures retained or purchased broken down by exposure type.

6.8.7 Aggregate amount of securitization exposures retained or purchased and the associated regulatory capital requirements by STS and/or IRBS, as the case may be, for these exposures broken down into risk-weight buckets. Exposures that have been deducted entirely from Core Capital, credit-enhancing I/Os and other exposures deducted from Core Capital and Supplementary Capital, as the case may be, must be disclosed separately by type of underlying asset.

6.8.8 For securitisations subject to early amortization provisions, the following items by underlying asset type for securitized facilities:

6.8.8.1 The aggregate drawn exposures attributed to the originator's and investors' interests;

6.8.8.2 The aggregate regulatory capital requirements by STS and/or IRBS Approach, as the case may be, incurred by the AI against its retained

(i.e. the originator's) shares of the drawn balances and undrawn balances;

6.8.8.3 The aggregate regulatory capital requirements by STS and/or IRBS Approach, as the case may be, incurred by the AI against the investors' interest in shares of drawn balances and undrawn balances.

6.8.9 Summary of AI's current year's securitization activity, including the amount of exposures securitized (by exposure type), and recognized gain or loss on sale by exposure type.

6.9 Market Risk

6.9.1 An AI subject to Part 6 must make the following disclosures:

6.9.2 Disclosures required from an AI using the STM Approach:

Qualitative

6.9.2.1 Disclose portfolios of exposures covered by the STM Approach.

Quantitative

6.9.2.2 The AI's regulatory capital requirements for:

- Interest rate exposures;
- Equity position exposures;
- Foreign exchange exposures;
- Commodities exposures.

6.9.3 Disclosures required from an AI using the IMA to calculate its exposure to market risk in respect of its trading book:

Qualitative

6.9.3.1 Disclose the portfolios of exposures covered by the IMA, and provide a discussion of the extent of and methodologies for the AI's compliance with the "Prudent valuation guidance" for positions held in the trading book in accordance with the HKMA's Guidance on [Market Risk Management]. The discussion must include an articulation of the soundness standards on which the AI's internal capital

adequacy assessment is based. It must also include a description of the methodologies used to achieve a capital adequacy assessment that is consistent with the soundness standards.

[Additional Guidance – the HKMA's Guidance on [Market Risk Management] is to be forthcoming.]

6.9.3.2 For each portfolio of exposures covered by the IMA:

- The characteristics of the model(s) used;
- A description of the stress testing applied by the AI to the portfolio;
- A description of the approach used for backtesting / validating the accuracy and consistency of the internal models and modelling processes.

<u>Quantitative</u>

6.9.3.3 For exposures in the AI's trading book under the IMA, the AI must disclose:

- The high, mean, and low VaR values over the reporting period and the VaR at period-end;
- A comparison of VaR estimates with actual gains / losses experienced by the AI, with an analysis of important "outliers" in backtest results.

6.9.4 Disclosures required from an AI using any other approach that has the prior consent of the HKMA for calculation of market risk in respect of its trading book:

<u>Qualitative</u>

6.9.4.1 The AI must provide information similar to that required in 6.9.3.1 to 6.9.3.2 above.

6.9.4.2 Where applicable, the HKMA may specify other disclosures which the HKMA considers necessary for the understanding of the AI's underlying market risk exposures.

Quantitative

6.9.4.3 The AI must provide information similar to that required in 6.9.3.3 above.

6.9.4.4 Where applicable, the HKMA may specify other disclosures which the HKMA considers necessary for the understanding of the AI's underlying market risk exposures.

6.10 Operational Risk

6.10.1 An AI subject to Part 6 must make the following disclosures:

Qualitative

6.10.2 Disclose the approach(es) for operational risk capital assessment for which the AI uses to calculate its exposure to operational risk for each standardized business line. AI using the BIA Approach must disclose the fact.

6.11 Equities : Disclosures for Banking Book Positions

6.11.1 An AI subject to Part 6 must make the following disclosures:

Qualitative

6.11.2 The general qualitative disclosures with respect to equity risk including:

6.11.2.1 Differentiation between holdings on which capital gains are expected and those taken under other objectives including for relationship and strategic reasons;

6.11.2.2 Discussion of important policies covering the valuation and accounting of equity holdings in the AI's banking book. This includes the accounting techniques and valuation methodologies used by the AI, including key assumptions and practices affecting valuation as well as significant changes in these practices.

Quantitative

6.11.3 The cumulative realized gains or losses arising from sales and liquidations of equity holdings in the reporting period.

6.11.4 Total unrealized gains or losses recognized in the AI's reserves but not through the profit and loss account, and any of these amounts included in the AI's Supplementary Capital for CAR purpose.

6.11.5 The AI's regulatory capital requirements broken down by equity groupings which is consistent with the AI's internal methodology, and the aggregate amounts and the type of equity investments subject to any supervisory transition or grandfathering provisions regarding regulatory capital requirements.

6.12 Interest Rate Risk in the Banking Book

6.12.1 An AI subject to Part 6 must make the following disclosures:

Qualitative

6.12.2 The general qualitative disclosures with respect to IRRBB, including the nature of IRRBB and key assumptions used by the AI in its measurement of IRRBB, including assumptions regarding loan prepayments and behaviour of non-maturity deposits where non-maturity deposit is a deposit without a fixed maturity, and frequency of IRRBB measurement.

Quantitative

6.12.3 The variations in earnings or economic value (or relevant measure used by the AI) for upward and downward interest rate shocks according to the AI's method for measuring IRRBB, broken down by currency (as relevant).

PART 7

HALF YEARLY DISCLOSURES BY DESIGNATED FOREIGN AIs

7. Application

7.1 This part applies to Designated Foreign AIs as defined in paragraph 2.1.3, Part 2 of the DRs.

7.2 Unless the context requires otherwise, a reference to an AI in this Part is a reference to a Designated Foreign AI as defined in paragraph 2.1.3, Part 2 of the DRs.

7A. GENERAL REQUIREMENTS

7A.1 Exceptions

7A.1.1 An AI must comply with the General Requirements set out in Part 2 of these DRs except:

- Paragraphs 2.1.1, 2.1.2, 2.2; 2.3.3; 2.3.4; 2.3.5; 2.4; 2.5; 2.6; 2.8; 2.9; 2.10; 2.11.1; 2.12 and 2.14.1. If the AI or its parent does not follow International Accounting Standards, it is also not required to comply with paragraph 2.7.

7A.2 Comparative Information

7A.2.1 For disclosures under section 7B, except the profit and loss information and liquidity ratio under subsections 7B.2 and 7B.5.14 respectively, the corresponding amounts for the immediately preceding financial period must be given (i.e. for the year-end Disclosure Statement, the interim figures must be disclosed as comparative figures and, for the interim Disclosure Statement, the immediately preceding year-end figures).

7A.2.2 For the profit and loss information and liquidity ratio under subsections 7B.2 and 7B.5.14 respectively, the amounts for the corresponding period of the preceding financial year must be given (i.e. for the year-end Disclosure Statement, the figures for the preceding financial year must be disclosed as comparative figures and, for the interim Disclosure Statement, the figures for the interim financial period of the preceding financial year).

7A.2.3 For disclosures under section 7C, except the pre-tax profit under subsection 7C.3.1, the corresponding amounts for the immediately preceding financial period must be given (i.e. for the year-end Disclosure Statement, the interim figures must be disclosed as comparative figures and, for the interim Disclosure Statement, the preceding year-end figures).

7A.2.4 For the pre-tax profit under subsection 7C.3.1, the amounts for the corresponding period of the preceding financial year must be disclosed (i.e. for the year-end Disclosure Statement, the figures for the preceding financial year must be disclosed as comparative figures and, for the interim Disclosure Statement, the figures for the interim financial period of the preceding financial year).

7A.2.5 Where interim consolidated information is not provided by the AI as a whole, annual figures must be provided as comparatives.

7A.2.6 Where the disclosures are published for the first time and it is impractical to provide the comparative figures required in 7A.2.1 to 7A.2.5 above, as the case may be, the disclosure in respect of the comparatives need not be provided for the first reporting period (i.e. no comparative is required).

7B. BRANCH INFORMATION DISCLOSURE

7B.1 General

7B.1.1 Part 7B shall apply to disclosures concerning the operations of the local branch (i.e. Hong Kong office) of the AI.

7B.2 Income Statement

7B.2.1 An AI must include the following profit and loss information in its Disclosure Statements:

- interest income;
- interest expense;
- other operating income:
  - gains less losses arising from dealing in foreign currencies;

- gains less losses on securities held for dealing purposes;
- gains less losses from other dealing activities;
- net fees and commission income (separate disclosure of gross fees and commission income and expenses must be given); and
- others;

▪ operating expenses (analysed where material);

▪ impairment losses and provisions for impaired loans and receivables;

▪ gains less losses from disposal of property, plant and equipment; and investment properties;

▪ profit before taxation;

▪ tax expense or tax income; and

▪ profit after taxation.

(Additional Guidance – the AI should refer to the mapping of the profit and loss information to the "Return of Current Year's Profit and Loss Account – MA(BS)1C" set out in the Guideline on Operation of the Disclosure Rules (at Annex).)

7B.2.2 Where the profit and loss information relating to the Hong Kong branch(es) does not give a full picture of the underlying performance of the AI's business in Hong Kong, the AI must provide such further explanation as is necessary for the understanding of the performance of the Hong Kong branch(es).

7B.3 Balance Sheet

7B.3.1 An AI must disclose the following balance sheet information in its Disclosure Statements:

(A) Assets

▪ cash and short-term funds (except those included in amount due from overseas offices);

▪ placements with banks maturing between one and twelve months (except those included in amount due from overseas offices);

▪ amount due from overseas offices of the AI;

- trade bills;
- certificates of deposit held;
- securities held for dealing purposes;
- loans and receivables:
  - loans and advances to customers;
  - loans and advances to banks;
  - accrued interest and other accounts (analysed where material);
  - provisions for impaired loans and receivables (analysed between those against loans and advances to customers, loans and advances to banks, other accounts if material):
    - collective provisions; and
    - specific provisions;
- investment securities;
- other investments;
- property, plant and equipment; and investment properties; and
- total assets.

(B) Liabilities

- deposits and balances of banks (except those included in amount due to overseas offices);
- deposits from customers:
  - demand deposits and current accounts;
  - savings deposits; and
  - time, call and notice deposits;
- amount due to overseas offices of the AI;
- certificates of deposit issued;
- issued debt securities;
- other liabilities

- provisions; and
- total liabilities.

7B.3.2 Where provisions for loans and advances or other exposures have been set aside and are maintained at overseas head offices, the AI must disclose the provisioning policy of its head offices including the amount of specific provisions allocated for exposures maintained in the Hong Kong offices of the AI.

7B.3.3 An AI must disclose:

- the amount of impaired loans and advances to customers which are subject to individual assessment for impairment loss;
- the amount of specific provisions made for such loans and advances; and
- the percentage of such loans and advances to total loans and advances to customers.

7B.3.4 An AI must also disclose information similar to that stated in 7B.3.3 above on loans and advances to banks that are subject to individual assessment for impairment loss.

7B.3.5 For the purpose of 7B.3.1 and 7B.3.4, "loans and advances to banks" means placements with banks of greater than one year maturity. "Deposits and balances of banks" means all amounts arising out of banking transactions owned by the AI to other banks; and excludes those balances taking the form of debt securities and certificates of deposits. "Issued debt securities" means all negotiable securities other than stocks, shares, import or export trade bills, or certificate of deposits.

7B.3.6 Where the specific provisions were made after taking into account the value of collateral in respect of such loans and advances, the AI must disclose this fact in order to put the level of provisioning into perspective.

(C) Derivatives

7B.3.7 An AI must disclose the contractual or notional amounts of each material class of derivative instruments, including:

- Exchange rate contracts (excluding forward foreign exchange contracts arising from swap deposit arrangements);
- Interest rate contracts; and

- Others.

7B.3.8 An AI must also provide such risk exposure information as is necessary for the understanding of the underlying risks of the exposures incurred by the AI through its use of derivative instruments. In particular, the AI must report aggregate fair value of their exchange rate contracts, interest rate contracts and other derivatives, if any. The AI must also indicate whether these amounts take into account the effects of valid bilateral netting arrangements.

7B.4 Off-Balance Sheet Exposures

7B.4.1 An AI must disclose the contractual or notional amounts of each material class of off-balance sheet financial instruments and analysed where material. At a minimum, these must include the following items:

Contingent liabilities and commitments

- Direct credit substitutes;
- Transaction-related contingencies;
- Trade-related contingencies;
- Note issuance and revolving underwriting facilities;
- Other commitments; and
- Others (including forward asset purchases, amounts owing on partly paid-up shares and securities, forward forward deposits placed, asset sales or other transactions with recourse).

7B.4.2 An AI must also provide such risk exposure information as is necessary for the understanding of the underlying risks of the off-balance sheet exposures incurred by the AI. In particular, the AI must report aggregate fair value of their contingent liabilities and commitments, if any. The AI must also indicate whether these amounts take into account the effects of valid bilateral netting arrangements.

7B.5 Supplementary Disclosures

(A) Credit Risk: General Disclosures by Designated Foreign AIs

7B.5.1 An AI must disclose the breakdown of its cross-border claims by major countries or geographical segments according to the location of the counterparties and by the types of counterparties (analysed into banks, public sector entities and others). The basis of the country or

geographical classification must be stated, including the fact that transfer of risk has been taken into account. Any country or geographical segment that constitutes 10% or more of the AI's aggregate cross-border claims after taking into account any risk transfers must be reported. Risk transfer may only be recognized if the claims are guaranteed by a party in a country which is different from that of the counterparty or if the claims are on an overseas branch of a bank whose head office is located in another country.

7B.5.2 Cross-border claims must include the following types of financial claims:

- receivables and loans and advances;
- balance due from banks;
- holdings of certificates of deposit, bills, promissory notes, commercial paper, other debt instruments and investments; and
- accrued interest and overdue interest on the above assets.

For the avoidance of doubt, claims arising between branches and subsidiaries of the AI must be excluded.

(Additional Guidance – the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) for further guidance on the disclosure of cross-border claims.)

7B.5.3 An AI must disclose the breakdown of the gross amount of loans and advances to customers by major countries or geographical segments according to the location of the counterparties. A breakdown of overdue loans and advances, and impaired loans and advances which are subject to individual assessment for impairment loss by these identified countries or geographical segments must also be given. Any country or geographical segment that constitutes 10% or more of the aggregate amount of loans and advances to customers after taking into account any risk transfer must be disclosed.

7B.5.4 An AI must disclose the breakdown of the gross amount of loans and advances to customers by major industry sectors. To achieve consistency of reporting among AIs, the information must be disclosed in accordance with the industry categories set out in this paragraph.

(Additional Guidance – the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) for further guidance on the types of loans and advances that should

be included in the respective categories as well as how the disclosure should be reported.)

- ***Loans and advances for use in Hong Kong***

  (a) Industrial, commercial and financial:

  – Property development;

  – Property investment;

  – Financial concerns;

  – Stockbrokers;

  – Wholesale and retail trade;

  – Manufacturing;

  – Transport and transport equipment;

  – Recreational activities;

  – Information technology; and

  – Others;

  (b) Individuals:

  – Loans for the purchase of flats in the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme;

  – Loans for the purchase of other residential properties;

  – Credit card advances; and

  – Others.

- ***Trade finance***

- ***Loans and advances for use outside Hong Kong***

7B.5.5 Additional credit risk information for the items referred to in 7B.5.4 such as the extent to which these loans and advances are backed by collateral or other security must also be disclosed.

[Additional Guidance – the items referred to in 7B.5.4 above should be broken down into more detailed sub-

categories, as applicable. The aggregate of the breakdown should be consistent with the relevant figures in the AI's balance sheet.]

7B.5.6 An AI must disclose the gross amount of loans and advances (to customers and banks) which have been overdue for:

- 6 months or less but over 3 months;
- 1 year or less but over 6 months; and
- over 1 year.

Both the absolute amount of overdue loans and advances to customers and the percentage of such loans and advances to total loans and advances to customers must be given for each maturity bucket. Total loans and advances to customers must correspond to the total of loans and advances for use in Hong Kong, trade finance, and loans and advances for use outside Hong Kong as disclosed in 7B.5.4 above. Similar information on overdue loans and advances to banks must also be disclosed.

7B.5.7 An AI must provide a description of collateral held against the overdue loans and advances as security and other credit enhancements and, unless impracticable, an estimate of their fair value. It must also disclose the amount of specific provisions made on such overdue loans and advances.

7B.5.8 An AI must disclose the amount of rescheduled loans and advances to customers, net of those that have been overdue for over 3 months and reported in 7B.5.6 above, and the percentage of such loans and advances to total loans and advances to customers. Similar information on rescheduled loans and advances to banks must also be given.

7B.5.9 An AI must disclose the amount of other assets, analysed by major categories of assets such as trade bills and debt securities, which have been overdue for:

- 6 months or less but over 3 months;
- 1 year or less but over 6 months; and
- over 1 year.

(Additional Guidance – For the purpose of 7B.5.6 to 7B.5.9 above, the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) for further guidance on

the classification and definition of overdue and rescheduled assets and on how to disclose the value of collateral held against overdue loans and advances.)

7B.5.10 An AI must disclose the amount of repossessed assets held and the accounting treatment of the related loans and advances, upon the repossession of the assets.

(B) Non-bank Mainland Exposures

7B.5.11 An AI must analyse the aggregate non-bank Mainland exposures to non-bank counterparties where such exposures are material.

(Additional Guidance – the AI should refer to the counterparty categories and the type of exposures as provided in the Guideline on Operation of the Disclosure Rules (at Annex) for the disclosure of non-bank Mainland exposures.)

(C) Currency Risk

7B.5.12 An AI must disclose foreign currency exposures arising from trading, non-trading and structural positions. The position in a particular foreign currency must be reported if the net position (in absolute terms) constitutes 10% or more of the AI's total net position in all foreign currencies. The financial information to be disclosed in respect of each such currency must include:

- Spot assets;
- Spot liabilities;
- Forward purchases;
- Forward sales;
- Net options position; and
- Net long (short) position.

An AI may calculate its net options position using either the Delta Equivalent Approach set out in the return "Foreign Currency Position" or the AI's internal reporting method provided that the basis of calculation is clearly stated.

7B.5.13 An AI must also report its net structural position (assets less liabilities) in a particular foreign currency (in absolute terms) if it constitutes 10% or more of the AI's total net structural position in all foreign currencies.

(Additional Guidance – the AI should refer to the Guideline on Operation of the Disclosure Rules (at Annex) for further guidance on the disclosure of currency risk.)

(D) Liquidity

7B.5.14 An AI must disclose its average liquidity ratio for the relevant financial period (i.e. 12 months for the year-end Disclosure Statement or 6 months for the half-year Disclosure Statement). The average liquidity ratio must be the simple average of each calendar month's average liquidity ratio reported by the AI to the HKMA pursuant to the BO.

7C. CONSOLIDATED GROUP LEVEL DISCLOSURES

7C.1 General

7C.1.1 Consolidated group level disclosures by an AI must be based on the most recent consolidated accounts of the AI as at the publication date of the Disclosure Statement, i.e. either the most recent annual accounts or interim accounts, whichever is available. Where the AI is owned by a holding company and does not itself publish consolidated accounts, the corresponding consolidated information for the group of which it is a part must be disclosed.

7C.1.2 An AI which does not publish interim accounts or publishes only unconsolidated information in its interim accounts must disclose the consolidated information in the most recent annual accounts.

7C.1.3 An AI must publish information on the location, for example the internet website, where the full annual accounts or interim accounts published by them (or the group of which they are a part) can be found.

7C.2 Capital and Capital Adequacy

7C.2.1 An AI must disclose its consolidated capital adequacy ratio, computed in accordance with the Basel II or the Capital Requirements Directive ("CRD"), whichever is applicable, as at the end of the date of the most recent annual accounts or interim accounts, whichever is available. The AI which does not observe the Basel II or the CRD must disclose this fact.

7C.2.2 An AI must disclose the aggregate amount of shareholders' funds (i.e. capital and reserves).

7C.3 Other Financial Information

7C.3.1 Subject to 7C.3.2, an AI must disclose the following consolidated financial information as at the date of its most recent annual or interim accounts:

- total assets;
- total liabilities;
- total loans and advances;
- total customer deposits (or total deposits); and
- pre-tax profit.

7C.3.2 Where total customer deposits are not separately disclosed in the annual accounts or interim accounts, the amount of total deposits (including those from banks and other financial institutions) of the AI may be disclosed instead. The basis of reporting must be clearly stated.

PART 8

IMPLEMENTATION AND TRANSITIONAL PROVISIONS

8.1 General

8.1.1 The purpose of this part is to provide guidance on transitional and implementation issues arising out of the contents of other parts of the DRs. In particular, this part sets out the transitional provisions applicable to Designated Local AIs which use or intend to use the FIRB Approach to calculate regulatory capital requirements for credit risk.

8.1.2 For the purpose of the provision of Part 8, "Transitional Period" is deemed to refer to and have the meaning of:

8.1.2.1 the relevant period leading to the rollout by the AI of the FIRB approach to the calculation of credit risk to measure its regulatory capital requirement;

8.1.2.2 the relevant period referred to in 8.1.2.1 shall not be more than three years, unless otherwise approved by the HKMA; and

8.1.2.3 includes the period within which the Designated Local AI is required to provide parallel run calculations of credit risk.

8.2 Transitional Provisions

8.2.1 During the Transitional Period, subject to the approval of the HKMA, where a Designated Local AI chooses to calculate the regulatory capital requirements of some of its portfolios of exposures; or designated asset classes; or business units, as the case may be, using an approach or combination of approaches, in addition to the portfolios for which it adopts FIRB Approach, then the Designated Local AI must comply with the disclosure requirements on the basis of the capital calculation approach in use for each such portfolio of exposures; or designated asset class; or business unit, as the case may be, as prescribed in these DRs.

Annex

GUIDELINE ON OPERATION OF THE DISCLOSURE RULES (DRS)

Section A

1. For the purpose of 2.3.2 of Part 2 – General Requirements of the DRs, where a Designated AI makes use of the option to provide detailed disclosures through the medium of a public internet website it should, at a minimum, make reference to the specimen disclosure templates set out at Attachments 1 to 3. Individual templates are applicable to the AIs as follows:

   Attachment 1 – for annual disclosure by Designated Local AIs

   Attachment 2 – for interim disclosure by Designated Local AIs

   Attachment 3 – for half-yearly disclosure by Designated Foreign AIs

Section B

1. The following parts within section B are applicable for disclosure for the purpose of Part 3 – Annual and Interim Financial Disclosures Applicable to Designated Local AIs of the DRs:

B.1 Geographical Concentrations of Income, Profit or Loss, Assets, Liabilities and Off-Balance Sheet Items

The following illustrates disclosure of geographical concentrations of income, profit or loss, assets, liabilities and off-balance sheet items:

1. Individual countries or geographical segments should be shown if they constitute 10% or more of any of the relevant disclosure items. AIs may use the composition of geographical segments set out below or a different composition of geographical segments defined by management for internal reporting purposes.

2. Individual items should be allocated on the basis of the location of the principal operations of the subsidiary or, in the case of the AI itself, on the location of the branch responsible for reporting the results or booking the assets.

	Total operating income	Profit/loss before taxation	Total assets	Total liabilities	Contingent liabilities & commitments
As at [reporting date]					
1. Hong Kong	xx	xx	xx	xx	xx
2. Asia Pacific excluding Hong Kong	xx	xx	xx	xx	xx
of which country A	xx	xx	xx	xx	xx
3. North and Latin America	xx	xx	xx	xx	xx
of which country B	xx	xx	xx	xx	xx
4. Middle East and Africa	xx	xx	xx	xx	xx
of which country C	xx	xx	xx	xx	xx
5. Western and Eastern Europe	xx	xx	xx	xx	xx
of which country D	xx	xx	xx	xx	xx
As at [last reporting date]					
1. Hong Kong	xx	xx	xx	xx	xx
2. Asia Pacific excluding Hong Kong	xx	xx	xx	xx	xx
of which country A	xx	xx	xx	xx	xx
3. North and Latin America	xx	xx	xx	xx	xx
of which country B	xx	xx	xx	xx	xx
4. Middle East and Africa	xx	xx	xx	xx	xx
of which country C	xx	xx	xx	xx	xx
5. Western and Eastern Europe	xx	xx	xx	xx	xx
of which country D	xx	xx	xx	xx	xx

B.2 Maturity Classification

The following set out the guidance on maturity classification:

1. Where an item is repayable by instalments, the repayments should be reported according to each instalment payment date and amount.

2. Items of a revolving nature should be reported according to:

   - the earliest date the asset will mature – if the AI has no notice of any intention of renewal by the borrower;
   - the next maturity date – if notice has been received on renewal of the loan or debt securities upon maturity; and
   - the final maturity date of the credit line – if the asset is to be renewed automatically on each rollover date.

3. Report any assets such as loans and debt securities which have been overdue for not more than one month as "Repayable on demand" and an asset which is impaired or which is overdue for more than one month as "Undated". Any loan which is repayable on demand (e.g. demand loans and overdrafts) should be treated as overdue where one or both of the following conditions are met:

   (i) a demand for repayment has been served on the borrower but repayment has not been made in accordance with the instruction; or

   (ii) the loan has remained continuously outside the approved limit that was advised to the borrower for more than the period in question (e.g. three months or six months).

4. In case of an asset which is repayable by different payments or instalments, only that portion of the asset which is actually overdue should be reported according to the method indicated above. Any part of the asset which is not due should continue to be reported according to the residual maturity unless the repayment of the asset is in doubt, in which case the amount should be reported as "Undated".

5. Unless otherwise indicated, liabilities should be classified according to their earliest maturity. In relation to deposits, this means the first roll-over date or the shortest period of notice required to effect a withdrawal.

6. Report demand, savings and current account deposits of customers as "Repayable on demand". Time, call and notice deposits of customers should be classified according to the earliest date on which these deposits may be withdrawn.

7. Negotiable debt instruments issued by the AI which are still outstanding and can be redeemed before maturity at the holder's option should be classified in the appropriate maturity bands according to the earliest date for redemption. Perpetual instruments should be reported as "Undated".

Section C

1. The following parts within section C are applicable for disclosure for the purposes of Part 3 – Annual and Interim Financial Disclosures Applicable to Designated Local AIs and Part 7 – Half Yearly Disclosures by Designated Foreign AIs of the DRs:

C.1 General Basis of Segmental Reporting

The following set out the general basis of segmental reporting by geographical segments:

Geographical segments

1. Depending on both an AI's activities and the nature of the markets concerned, reportable geographical segments may be based on continents, other regional areas, whether compatible for geographical or economic reasons, and/or individual countries. An AI's operations within Hong Kong are considered to be a separate geographical segment.

Intra-group items

2. AIs will need to determine, in the light of their individual circumstances, whether it would be more meaningful to include or exclude intra-group items when preparing segmental information. Where the individual segmental analysis is shown inclusive of intra-group transactions, it will be necessary to show separately the aggregate of intra-group items deducted in order to reconcile with the consolidated totals for profits and assets.

General

3. Where an AI operates predominantly in one geographical segment, the AI needs only indicate the geographical segment in which the AI predominantly operates.

4. Where allocation of an item of revenue, expense, or assets cannot be made to segments on a reasonable basis, no allocation should be made and the unallocated amount should be adjusted against the revenue, expense or assets of all segments. The unallocated amounts should be disclosed. Where allocation of an item involves a material judgement, the basis of allocation should be clearly stated.

5. In the event that segments are redefined in subsequent years, an AI should disclose the nature, reason for and effects of such change, where the change has a material effect on the segment information.

6. When a particular segment is regarded as material and disclosed for the first time, comparative figures for the previous year should be provided. Conversely, when a segment falls below the material level in the year of reporting the segmental information should still be disclosed if the prior year comparatives were material and disclosed in the previous year.

C.2 Cross-border Claims

The following illustrates geographical disclosure of cross-border claims by types of counterparties:

1. An individual country or geographical segment should be reported if it constitutes 10% or more of the aggregate cross-border claims after taking into account any risk transfer. Risk transfer should be made if the claims are guaranteed by a party in a country which is different from that of the counterparty or if the claims are on an overseas branch of a bank whose head office is located in another country.

2. Claims arising between branches and subsidiaries of the AI should be excluded.

3. AIs may use the composition of geographical segments set out below or a different composition of geographical segments defined by management for internal reporting purposes.

4. AIs should refer to the table set out below on the types of counterparties in accordance with the definitions set out in Part 1 of the DRs for making the disclosure.

	Banks	Public Sector Entities	Others*	Total
As at [reporting date]				
1. Asia Pacific excluding Hong Kong	xx	xx	xx	xx
of which country A	xx	xx	xx	xx
2. North and Latin America	xx	xx	xx	xx
of which country B	xx	xx	xx	xx
3. Middle East and Africa	xx	xx	xx	xx
of which country C	xx	xx	xx	xx
4. Western and Eastern Europe	xx	xx	xx	xx
of which country D	xx	xx	xx	xx
As at [last reporting date]				
1. Asia Pacific excluding Hong Kong	xx	xx	xx	xx
of which country A	xx	xx	xx	xx
2. North and Latin America	xx	xx	xx	xx
of which country B	xx	xx	xx	xx
3. Middle East and Africa	xx	xx	xx	xx
of which country C	xx	xx	xx	xx
4. Western and Eastern Europe	xx	xx	xx	xx
of which country D	xx	xx	xx	xx

*** includes Sovereign**

C.3 Analysis of Loans and Advances to Customers by Industry Sectors

The following set out the guidance for the analysis of gross loans and advances to customers by major industry sectors:

1. AIs should disclose the breakdown of the gross amount of loans and advances to customers by major industry sectors in accordance with the industry categories as set out in the table below. The allocation of loans and advances to customers and the types of loans and advances that should be included in the respective categories should be in accordance with the definitions and the detailed descriptions in the Completion Instructions for the Return of "Quarterly Analysis of Loans and Advances and Provisions - MA(BS)2A".

2. The relation between the industry sectors and the respective items in the Return is also set out in the table below.

3. While Part I of the Return deals only with the position of the Hong Kong office(s) of the AI, the analysis required in the DRs should cover all loans and advances to customers on a consolidated basis where applicable.

Industry classification	Advances included in the following item(s) of the Return (Part I)
Loans and advances for use in Hong Kong	
Industrial, commercial and financial:	
▪ Property development	Item B1e
▪ Property investment	Item B2e
▪ Financial concerns	Item H2e
▪ Stockbrokers	Item H3c
▪ Wholesale and retail trade	Item F
▪ Manufacturing	Items A10
▪ Transport and transport equipment	Item G6
▪ Recreational activities	Item D
▪ Information technology	Item E3
▪ Other	Items B3, C, H1, H4c, H5d and H6
Individuals	
▪ Loans for the purchase of flats in the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	Item H5a
• Loans for the purchase of other residential properties	Item H5b
• Credit card advances	Item H5c
• Others	Item H5e
Trade finance	Item J
Loans and advances for use outside Hong Kong	Item K

C.4 Overdue and Rescheduled Assets

The following set out the criteria which are to be applied in determining overdue and rescheduled assets:

Overdue assets

1. The overdue status of the following assets are to be determined as follows:-

    a) Loans with a specific expiry date (e.g. a term loan, inward bill loan, advance against trust receipt, packing loan and other loans of similar nature) - these loans should be treated as overdue where the principal or interest is overdue and remains unpaid as at the reporting date. (For multiple loans to a single borrower, e.g. where there are more than one trust receipt loans, report only the one overdue according to its overdue period.)

    b) Consumer loans repayable by regular instalments (e.g. residential mortgage loans, hire purchase loans and personal loans) - these loans should be treated as overdue when an instalment payment is overdue and remains unpaid as at the reporting date.

    c) Loans repayable on demand (e.g. demand loans and overdrafts) - these loans should be treated as overdue where one or both of the following conditions are met:

        i) a demand for repayment has been served on the borrower but repayment has not been made in accordance with the instruction; or

        ii) the loan has remained continuously outside the approved limit that was advised to the borrower for more than the period in question (e.g. three months or six months).

    d) Bankers acceptances are to be treated as overdue where either the principal or interest of the instruments are still in arrears after the due dates or maturity dates.

    e) A bill payable at a determinable date (i.e. usance bill) should be treated as overdue if it remains in arrears after the maturity date. Sight bills/drafts in respect of goods exported from Hong Kong should normally be paid within one week from the date of presentation (or the arrival of carrying vessel if the buyer is not obliged to pay before the arrival of goods). However, to allow for unforeseeable delays in processing the documents or effecting payments, a grace period of one month will be allowed. These bills should therefore be regarded as overdue if payment is not made within one month after presentation or the arrival of carrying vessel, as the case may be.

2. The period of overdue of a loan which has a determinable due date should commence from the date following such due date. The <u>whole amount</u> of a loan is regarded as overdue even if part of it is not yet due and assessment should be made by reference to the earliest due date of such a loan. For example, if the longest overdue instalment of a loan repayable by monthly instalments has been overdue for six months as at the reporting date, the entire amount of the loan should be considered as overdue for six months.

3. Where partial repayment of an overdue loan repayable by monthly instalments is made, to the extent that it is not financed by a new loan extended by the AI for the purpose of repaying the overdue loan, the repayment should be offset against the earliest instalments due. In the previous example, if the borrower makes a partial repayment reducing the longest overdue instalment to five months, the entire loan may be considered as overdue for five months.

4. If an overdue loan is scheduled to be repaid by a lump sum payment, a partial repayment will not change the overdue status of the remaining loan balance, i.e. the outstanding balance should continue to be treated as overdue with reference to the original due date.

5. An AI should not extend a new loan to a borrower solely for the purpose of repaying an existing overdue loan with the AI. Where the repayment whether partial or whole is financed by a new loan extended by the AI, the overdue status of the initial loan should be considered as unchanged, i.e. as if the new loan and partial repayment had never been made.

6. It is recognised that AIs may decide to increase overdraft limits (or limits of similar facilities) to accommodate the increased financing needs of sound customers. In such cases, the loan would not be regarded as overdue under paragraph 1(c)(ii) above. However, this should only be done on the basis of a well-documented credit evaluation and after the appropriate internal approval have been obtained. An increase in the overdraft limit should not be sanctioned simply to avoid classifying the loan as overdue.

<u>Rescheduled assets</u>

7. Rescheduled assets refer to loans and other assets that have been restructured and renegotiated between the AI and the borrower because of a deterioration in the financial position of the borrower or of the inability of the borrower to meet the original repayment schedule and for which the revised repayment terms, either of interest or of repayment period, are 'non-commercial' to the AI. A rescheduled asset will normally require an adverse classification under the loan classification system (i.e. substandard or doubtful).

8. The following assets are not regarded as rescheduled even if their repayment terms have been revised:

a) Assets rescheduled in response to the changes in market conditions provided that at the time of rescheduling, the assets have been serviced normally, the ability of borrowers to service the assets according to the revised repayment terms is not in doubt and the rescheduled assets are priced at interest rates equal to the current market interest rates for new assets with similar risks.

b) Rescheduled assets whose revised repayment terms are, or become, commercial to the AI and where there is reasonable assurance that the borrowers will be able to service all future principal and interest payments on the assets in accordance with the revised repayment terms <u>and</u> the borrowers have serviced all principal and interest payments on the assets in accordance with the revised repayment terms continuously for a reasonable period. The reasonable period of continuing repayments for rescheduled assets with monthly payments (including both interest and principal) is 6 months. For other rescheduled assets, a period of continuing repayment of 12 months would be considered as reasonable.

9. If a rescheduled asset is taken up by a new obligor, the AI may regard it as a new asset (i.e. no longer a rescheduled asset) and classify it according to the creditworthiness of the new obligor provided that :

a) it is restructured with the new obligor on commercial terms;

b) the agreed haircut, if any, has been fully written off upon completion of restructuring; and

c) it is a genuine restructuring and not merely a transfer of an overdue loan among the borrower's group companies. The AI must be satisfied with the creditworthiness and repayment ability of the new obligor (e.g. the new obligor must have sufficient assets that can generate adequate funds to repay the outstanding debt) before entering into the restructuring.

10. A rescheduled asset may be upgraded to "special mention" if: i) the agreed haircut has been fully written off and all the potential losses have been fully provided upon completion of restructuring; and ii) the AI is satisfied that the borrower will be able to service all future principal and interest payments in accordance with the revised repayment terms. Such asset will however continue to be regarded as rescheduled until the borrowers have serviced all principal and interest payments on the assets in accordance with the revised repayment terms continuously for a reasonable period (see paragraph 8 above).

C.5 Disclosure of Value of Collateral Held Against Overdue Loans

The following illustrates how AIs should disclose the collateral value of their overdue loans and the split between the portion of the overdue loans covered by credit protection (covered portion) and the remaining portion (uncovered portion):

HK$ million

Overdue loans	Outstanding loan amount (Note 1)	Current market value of collateral (Note 2)	Covered portion	Uncovered portion
A	10	15	10	-
B	10	7	7	3
C	10	-	-	10
Total	**30**	**22**	**17**	**13**

Note 1 – Outstanding loan amount will be principal amount, net of specific provisions if any, and the application of haircut if comprehensive approach is used in capital treatment for the use of collateral as recognized credit risk mitigation.

Note 2 – The current market value of collateral has to take into account haircut as applicable. For instance, haircut for currency risk will be applied to the collateral when the overdue loans and the collateral are denominated in different currencies.

Minimum information to be disclosed by the AI:

Current market value of collateral held against the covered portion of overdue loans	HK$ 22 million
Covered portion of overdue loans	HK$ 17 million
Uncovered portion of overdue loans	HK$ 13 million

2. The AI should provide sufficient explanation on any material difference between the disclosure amount and the accounting, although line by line reconciliation is not required.

3. Where multiple loans extended to one borrower are in aggregate secured partially by the same collateral, and one of the loans has been overdue for more than 3 months, the proportion of the value of the collateral held against the overdue loan disclosed should be the same as the proportion of the value of the collateral held against the different loans in aggregate. For example, if the different loans to one borrower are in aggregate 80% secured by the same collateral, it is assumed that each of the loans, including the overdue loans, should also be 80% secured. The AI should therefore disclose as the value of the collateral held against the overdue loan 80% of the outstanding amount of the overdue loan. If, however, the current market value of the collateral has

fallen to below 80% of the aggregate outstanding amount of the loans, the value of the collateral held against the overdue loan should also be adjusted accordingly.

C.6 Non-bank Mainland Exposures

The following illustrates the disclosure of the aggregate non-bank Mainland exposures to non-bank counterparties where such exposures are material:

1. For the categories of non-bank counterparties and the type of direct exposures to be disclosed, AIs should make reference to the Completion Instructions for Note (6) of the Return of "Quarterly Analysis of Loans and Advances and Provisions - MA(BS)2A".

2. While Note (6) of the Return deals only with the position of the Hong Kong office(s) of the AI, the analysis required in the DRs should cover all non-bank Mainland exposures to non-bank counterparties on a consolidated basis where applicable.

HK$ million

Types of Counterparties	*Referred items in the Return Note (6)*	**[A]** **On-balance sheet exposure** *i.e. column (2) in the Return Note (6)*	**[B]** **Off-balance sheet exposure** *i.e. sum of column (3) to (5) in the Return Note (6)*	**[A] + [B]** **Total**	**Specific provisions**
Mainland entities	*Aggregate of Item (a) to (d) of column (1)*				
Other entities incorporated or established in Mainland	*Item (e) of column (1)*				
Companies and individuals outside Mainland where the credit is granted for use in Mainland	*Item (f) of column (1)*				
Other counterparties where the exposure is considered by the AI to be non-bank Mainland exposure	*Item (g) of column (1)*				
Total					

C.7 Currency Risk

The following illustrates the disclosure of currency risk including exposures arising from option positions and structural positions:

1. AIs should disclose foreign currency exposures arising from trading, non-trading and structural positions.

2. An individual currency should be reported if its net position (in absolute terms) constitutes 10% or more of the AI's total net position in all foreign currencies. Similarly, for disclosure of the net structural position (assets less liabilities), an individual currency should be reported if its net structural position (in absolute terms) constitutes 10% or more of the AI's total net structural position in all foreign currencies.

3. AIs may calculate the net options position using either the Delta Equivalent Approach by referring to the definition in Part 1 of the DRs or using the AI's internal reporting method provided that the basis of calculation is clearly stated.

4. For the types of foreign currency positions and the amount to be reported, AIs should make reference to the Completion Instructions for the Return of "Foreign Currency Position – MA(BS)6".

Equivalent in millions of HK$	**US$**	**Euro**	**Japanese Yen**	**Total**
a. Spot assets	200	150	500	850
b. Spot liabilities	(100)	(50)	(100)	(250)
c. Forward purchases	350	100	100	550
d. Forward sales	(550)	(400)	(350)	(1,300)
e. Net option position	(100)	(200)	(80)	(380)
f. Net long (short) position (i.e. sum of (a) to (e))	(200)	(400)	70	(530)
	US$	**Can$**	**Euro**	**Total**
Net structural position	180	(15)	(40)	125

Section D

1. The following part within section D is applicable for disclosure for the purpose of Part 7 – Half Yearly Disclosures by Designated Foreign AIs of the DRs:

D.1 Mapping the Profit and Loss Information required in the DRs to the Banking Return

The following illustrates the mapping of profit and loss information as required to be disclosed in the DRs to the Return of "Current Year's Profit and Loss Account – MA(BS)1C":

Name of Return: Current Year's Profit and Loss Account

Disclosure Statement		Banking Return	
Item	**Description**	**Item**	**Description**
(i)	Interest income	I.1.1	Interest income
(ii)	Interest expense	I.1.2	Interest expense
(iii)	Other operating income		
	- Gains less losses arising from dealing in foreign currencies	I.2.1A	Gains less losses arising from trading in foreign currencies
		I.2.1B	Gains less losses arising from non-trading activities in foreign currencies
	- Gains less losses on securities held for dealing purposes	I.3.1	Investments held for trading
	- Gains less losses from other dealing activities	I.2.2	Gains less losses arising from trading in interest rate derivatives
		I.2.3	Gains less losses arising from trading in other derivatives
	- Net fees and commission income	I.4	Income from fees and commissions (item I.4) less fees and commission expenses
	- Others	I.3.2	Dividend from subsidiary/associated companies and other equity investments
		I.3.3	Income from non-trading investments
		I.6	Other income

Disclosure Statement		Banking Return	
Item	**Description**	**Item**	**Description**
(iv)	Operating expenses	I.8 I.9 I.11	Staff and rental expenses Other expenses less fees and commission expenses Net charge for other provisions
(v)	Impairment losses and provisions for impaired loans and receivables	I.10	Net charge/(credit) for debt provision
(vi)	Gains less losses from disposal of property, plant and equipment; and investment properties	I.5	Profit/(loss) on sale of fixed assets
(vii)	Profit before taxation	I.13	Profit/(loss) before tax
(viii)	Tax expense or tax income	I.14	Net charge for tax provision
(ix)	Profit after taxation	I.17	Profit/(loss) for the period

Disclosure Template For Designated Local AIs (Annual Disclosure)

Attachment 1

Description	Disclosures Specific to Designated Local AIs Using the					
	Basic Approach		Standardised Approach		Foundation or Advanced IRB Approach	
	Qualitative	Quantitative	Qualitative	Quantitative	Qualitative	Quantitative
GENERAL DISCLOSURE						
Scope of Consolidation						
Principal Accounting Policies						
Financial Accounts Information		e.g. attach a link to website or a file				
Supplementary Disclosures						
(a) Capital Structure and Adequacy						
(b) Credit Risk: General Disclosures						
(c) Non-bank Mainland Exposures						
(d) Currency Risk						
(e) Liquidity						
(f) Corporate Governance						
SPECIFIC DISCLOSURE						
Capital Adequacy						
General Qualitative Disclosures						
Credit Risk :						
- specific disclosures						
- portfolios subject to Supervisory Estimates in the IRB						
Counterparty Credit Risk-related Exposures - general disclosures						
Credit Risk Mitigation						
Asset Securitisation						
Market risk						
Operational Risk						
Equities : Disclosures for Banking Book Positions						
Interest Rate Risk in the Banking Book						

(represents "not applicable")

Attachment 2

Disclosure Template For Designated Local AIs (Interim Disclosure)

Description	Disclosures Specific to Designated Local AIs for All Credit Risk Approach
GENERAL DISCLOSURE	
Scope of Consolidation	
Financial Accounts Information	e.g. attach a link to website or a file
Supplementary Disclosures	
(a) Capital Structure and Adequacy	
(b) Credit Risk: General Disclosures	
(c) Non-bank Mainland Exposures	
(d) Currency Risk	
(e) Liquidity	

Attachment 3

Disclosure Template For Designated Foreign AIs

Description	
BRANCH LEVEL	
General Information	
Financial Accounts Information	e.g. attach a link to website or a file
Supplementary Disclosures	
(a) Credit Risk: General Disclosures	
(b) Non-bank Mainland Exposures	
(c) Currency Risk	
(d) Liquidity	
CONSOLIDATED GROUP LEVEL	
General Information	
Capital and Capital Adequacy	
- Capital adequacy ratio	
- Basis of computation	
- Aggregate amount of shareholders' funds	
Other Financial Information	
- Total Assets	
- Total Liabilities	
- Total Loans and Advances	
- Total Customer Deposits (or total deposits)	
- Pre-tax profit	

(represents "not applicable")

Attachment 4

Disclosure template for items 5.4.5, 5.4.6 and 5.4.7 of Part 5

Portfolios		Total Exposures*	Exposures after Recognized Credit Risk Mitigation		Risk-weighted Amounts	Risk-weighted Amounts	Total Risk-weighted Amounts
			Rated	Unrated	Rated	Unrated	
A. On-balance Sheet							
1.	**Sovereigns**						
2.	**Public Sector Entities**						
3.	**Multilateral Development Banks**						
4.	**Banks**						
5.	**Securities Firms**						
6.	**Corporates**						
7.	**Cash Items**						
8.	**Regulatory Retail Exposures**						
9.	**Residential Mortgage Loans**						
10.	**Other Assets which are not Past Due Exposures**						
11.	**Past Due Exposures**						
B. Off-balance Sheet							
1.	**Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts**						
2.	**OTC derivative transactions**						
3.	**Credit derivative contracts**						
4.	**Other off-balance sheet exposures not elsewhere specified**						
Exposures deducted from Capital Base							

* principal amount or credit equivalent amount, as applicable, net of specific provisions

Disclosure for item 5.4.5

Disclosure for item 5.4.6

Disclosure for item 5.4.7