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LEGISLATIVE COUNCIL BRIEF

Banking Ordinance
(Cap.155)

BANKING (CAPITAL) RULES

BANKING (DISCLOSURE) RULES

INTRODUCTION

For implementing a revised framework for the capital adequacy and disclosure requirements for authorized institutions (AIs) in line with the international standard known as "Basel II"[1], the Hong Kong Monetary Authority (HKMA) has published in the Gazette the following rules made by the Monetary Authority (MA) under sections 98A and 60A of the Banking Ordinance ("the Ordinance") as amended by the Banking (Amendment) Ordinance 2005 –

(a) Banking (Capital) Rules; and

(b) Banking (Disclosure) Rules

(which are hereafter referred to respectively as "Capital Rules" and "Disclosure Rules", and collectively as "the Rules").

BACKGROUND

2. The Administration, in line with its established practice of subscribing to the supervisory standards recommended by the Basel Committee on Banking Supervision (BCBS), reached the decision, after full consultation with the banking industry and other interested parties, to introduce the revised capital adequacy and disclosure framework known as Basel II from January 2007. The Banking (Amendment) Ordinance 2005, enacted in July 2005, provides the legal basis for the HKMA to implement Basel II in Hong Kong. In particular,

[1] The revised capital adequacy framework promulgated by the Basel Committee on Banking Supervision in June 2004 in its document entitled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" is commonly known as Basel II. It substantially amends the Capital Accord of 1988 known as "Basel I" on capital adequacy requirements for banks' exposures to credit risk, which was subsequently amended in 1996 to incorporate market risk. Hong Kong has implemented Basel I and its subsequent amendments.

section 98A of the Ordinance provides that the capital adequacy ratio (CAR) of locally incorporated authorized institutions (referred to as "local institutions") shall be calculated in a manner prescribed in rules to be made by the MA under the Ordinance. The Ordinance also provides that AIs shall disclose publicly information on their state of affairs, profit and loss and CAR in a manner prescribed in rules to be made by the MA under section 60A.

3. These rules have the status of subsidiary legislation and are subject to negative vetting by the Legislative Council (LegCo). The MA is subject to the statutory duty to consult the Banking Advisory Committee (BAC), the Deposit-taking Companies Advisory Committee (DTCAC), The Hong Kong Association of Banks (HKAB), the DTC Association (DTCA) and the Financial Secretary (FS) when making the rules.

JUSTIFICATIONS

The Capital Rules

4. Basel II is structured around three "pillars". Pillar 1 sets out the minimum capital requirements for a bank's operational risk, in addition to revising the "Basel I" treatment of credit risk and market risk. 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 through enhanced market transparency and market discipline by requiring banks to make public disclosure of information on their risk profiles, capital adequacy and risk management.

5. The definitions of "capital adequacy ratio" and "capital base" under the Ordinance and the Capital Rules made by the MA under the Ordinance will govern the calculation of the CAR of a local institution as set out under Pillar 1. Under section 2(1) of the Ordinance, CAR in relation to a local institution means the ratio of the institution's capital base to a value representing the degree of credit risk, market risk and operational risk to which the institution is exposed. The definition of the three types of risk is embodied in the definition of CAR[2]. These definitions are essential to ensure that the supervisory

[2] **Credit risk** means the risk of loss from (i) default by counterparties in on-balance sheet and off-balance sheet transactions of the institution; or (ii) diminution in the value of such on-balance sheet items of the institution as may be prescribed by the MA in rules made under section 98A(1) of the Ordinance;

Market risk means the potential losses arising from fluctuations in the value of positions held by the institution (i) for trading purposes in debt securities, interest rate-related contracts, equities and equities-related contracts; and (ii) in foreign exchange, exchange rate-related contracts, commodities and commodities-related contracts;

standards on capital adequacy in Hong Kong to be set out in the Capital Rules are in line with the requirements of Basel II and that the MA's power to make rules under the Ordinance is limited to the power to make rules for the implementation of Basel II. Further, the value representing the degree of the three types of risk may be calculated in a variety of ways depending upon the type of risk and the calculation approach to be adopted. The Capital Rules set out in detail the different calculation approaches that can be adopted.

The Disclosure Rules

6. The purpose of the Disclosure Rules is to set out the minimum standards for public disclosure which AIs must make in respect of their state of affairs, profit and loss and CAR. They also prescribe the manner in which the disclosures should be made as well as the timing of disclosures including periods during which such information shall be so disclosed. AIs have been subject to an extensive disclosure regime for many years (for example, section 60 of the Ordinance provides for the public disclosure of AIs' audited financial accounts), and the standards contained in the Disclosure Rules represent an evolution of the HKMA's existing Financial Disclosure Guidelines[3].

7. The recommended disclosures under the Disclosure Rules mirror the emphasis in the new capital adequacy framework on a more risk- and principles-based approach to regulation that focuses closely on an AI's own assessment and management of the risks facing its business. In line with these recommendations, and consistent with the "through the eyes of management" approach adopted by International Financial Reporting Standards (IFRS), the HKMA has introduced a larger risk-focused element into AIs' disclosures than hitherto. The objectives of the required disclosures are two-fold. First, to allow market participants to obtain key pieces of information on the capital, risk exposures, risk assessment processes, and hence the capital adequacy of AIs. Secondly, to encourage AIs to demonstrate that their risk management systems are robust and that all relevant risks have been identified and controlled. As such, the scope and extent of disclosures required under the Disclosure Rules depend largely on the nature, size, and level of complexity and sophistication of the business of individual AIs.

8. The HKMA has also taken the opportunity to up-date its disclosure regime by taking into account the additional disclosure requirements under the Financial Reporting Standards, especially *Hong Kong Financial Reporting*

Operational risk means the risk of direct or indirect losses resulting from (i) inadequacies or failings in the processes or systems, or of personnel of the institution; or (ii) external events.

[3] The following are the relevant modules of the HKMA Supervisory Policy Manual :
(a) FD-1 ("Financial Disclosure by Locally Incorporated Authorized Institutions");
(b) FD-2 ("Interim Financial Disclosure by Locally Incorporated Authorized Institutions"); and
(c) FD-3 ("Financial Disclosure by Overseas Incorporated Authorized Institutions")
issued by the HKMA.

Standard 7 – Financial Instruments: Disclosures and the changes to the balance sheet and income statement of AIs that flowed from the adoption in Hong Kong of International Accounting and Financial Reporting Standards (IAS/IFRS) at the beginning of 2005. In addition, the Disclosure Rules, in response to extensive consultation with users of financial disclosures, contain provisions for enhanced disclosures of AIs' exposures to Mainland China.

9. With effect from 1 January 2007 the Capital Rules will replace the Third Schedule to the Ordinance, which prescribes the calculation methodology for the CAR under Basel I, and the Disclosure Rules will replace the existing Financial Disclosure Guidelines issued by the HKMA. The HKMA will issue further guidance to AIs on the manner in which the MA interprets and proposes to operate the Rules.

THE RULES

The Capital Rules

10. The Capital Rules are divided into nine parts, with their major objectives and provisions as follows.

Part 1 – Preliminary

11. This Part defines the terms used generally throughout the Capital Rules and specifies how the CAR shall be calculated. Specifically, section 3 specifies that the CAR of a local institution shall be calculated as the ratio, expressed as a percentage, of the institution's capital base to the aggregate of its risk-weighted amounts for credit risk, market risk and operational risk. "Risk-weighted amount" in relation to the calculation of the three types of risk of a local institution is to be calculated in accordance with Part 4, 5 or 6 (under the standardized (credit risk) approach, the basic approach or the internal ratings-based (IRB) approach for the institution's non-securitization exposures to credit risk); Part 7 (under the standardized (securitization) approach or the IRB (securitization) approach for the institution's securitization exposures to credit risk); Part 8 (under the standardized (market risk) approach or the internal models approach for the institution's exposures to market risk); and Part 9 (under the basic indicator approach, the standardized (operational risk) approach or the alternative standardized approach for the institution's exposures to operational risk).

Part 2 – Prescribed approaches in relation to calculation of CAR

12. This Part specifies the various approaches a local institution must, or with the approval of the MA, may use to calculate its credit, market and operational risks and the qualifying criteria for using approaches other than the

"default" approach.

Credit risk

13. A local institution must use the standardized (credit risk) approach to calculate its credit risk for non-securitization exposures unless it has the approval of the MA to use the basic approach or the IRB approach to calculate its credit risk for such exposures. The MA may only grant approval for a local institution use of the basic approach or the IRB approach if the institution satisfies the requirements of section 7 or 8 (including Schedule 2) respectively.

14. Subject to certain specified exceptions, a local institution must use the standardized (securitization) approach to calculate its credit risk for the securitization exposures in a securitization transaction if it would use the standardized (credit risk) approach or the basic approach to calculate its credit risk for the underlying exposures in the transaction. Similarly, a local institution must use the IRB (securitization) approach to calculate its credit risk for the securitization exposures in a securitization transaction if it would use the IRB approach to calculate its credit risk for the underlying exposures in the transaction.

Market risk

15. A local institution (except an institution exempted under section 22) must use the standardized (market risk) approach to calculate its market risk unless it has the approval of the MA to use the internal models approach to calculate its market risk. The MA may only grant approval for an institution to use the internal models approach if it satisfies the requirements of Schedule 3. Section 20 also provides that an institution may use the approach adopted by its parent bank to calculate market risk if it has the MA's approval to do so. In addition, an institution with a small market risk position may be exempted by the MA under section 22 from the calculation of market risk.

Operational risk

16. A local institution must use the basic indicator approach to calculate its operational risk unless it has the approval to use the standardized (operational risk) approach or the alternative standardized approach to calculate its operational risk. The MA may only grant approval for an institution to use the standardized approach or the alternative standardized (operational risk) approach if it satisfies the requirement of Schedule 4.

Calculation basis

17. This Part also specifies the requirement of a local institution to calculate its CAR on a solo basis, solo-consolidated basis or consolidated basis.

Section 27(2) provides that the MA may require the CAR of a local 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), if more than 50% of the subsidiary's total assets or total income arise from the carrying out of relevant financial activities set out in section 27(3).

Part 3 – Determination of Capital Base

18. This Part specifies how a local institution shall determine its capital base for calculating its CAR, that is to add together the institution's core capital (as defined under section 38) and supplementary capital (as defined under section 42) and to make such deductions as are specified in section 48 and Schedule 5. Section 37 specifies the essential characteristics that a local institution's core capital or supplementary capital must possess in order for such capital to be included in the institution's capital base.

Part 4 – Standardized approach to calculation of credit risk for non-securitization exposures

19. This Part and Schedules 6 and 7 set out the technical details that a local institution must comply with in using the standardized (credit risk) approach to calculate its credit risk for non-securitization exposures. In particular, section 54 provides that an institution shall classify each of its exposures, according to the obligor or the nature of the exposure, into 12 specified classes and Division 3 provides that the risk-weight for exposures under the classes of sovereign exposures, public sector entity exposures, bank exposures, securities firm exposures, corporate exposures, and collective investment scheme exposures shall be determined according to the relevant ratings assigned by recognized external credit assessment institutions. Divisions 5 to 10 provide that an institution may use credit risk mitigation in the form of specified types of collateral, guarantees, credit derivative contracts and netting in reducing the risk-weighted amount of the institution's exposures, subject to the specified conditions being met.

Part 5 – Basic approach to calculation of credit risk for non-securitization exposures

20. This Part sets out the technical details that a local institution must comply with in using the basic approach to calculate its credit risk for non-securitization exposures. In particular, section 108 provides that an institution shall classify each of its exposures, according to the obligor or the nature of the exposure, into seven specified classes, being sovereign exposures; public sector entity exposures; multilateral development bank exposures; bank exposures; cash items; residential mortgage loans; and other exposures. Division 3 specifies the risk-weights for each of these classes of exposures. Divisions 5 to 8 provide that an institution may use credit risk mitigation in the

form of specified types of collateral, guarantees, credit derivative contracts and netting to reduce the risk-weighted amount of the institution's exposures, subject to the specified conditions being met.

Part 6 – IRB approach to calculation of credit risk for non-securitization exposures

21. This Part and Schedule 2 set out the technical details that a local institution must comply with in using the IRB approach to calculate its credit risk for non-securitization exposures. In particular, Division 2 provides that an institution shall classify each of its exposures into one of the six IRB classes, being corporate exposures, sovereign exposures, bank exposures, retail exposures, equity exposures and other exposures. Division 3 requires an institution to select one of the IRB calculation approaches applicable to the six IRB classes. Divisions 5 to 9 set out the technical details for the calculation of credit risk for an institution's exposures which fall under each of the IRB classes. Division 10 provides that an institution may take into account the effect of credit risk mitigation in calculating the risk-weighted amount of its exposures. Division 11 specifies the adjustment an institution shall make to its capital base in respect of the difference between the total expected loss amount and the total eligible provision of its exposures under the IRB approach. Division 12 requires an institution to multiply the risk-weighted amount of its exposures by a scaling factor to arrive at the institution's total risk-weighted amount for credit risk. Division 13 requires an institution to be subject to a capital floor during the first three years of adoption of the IRB approach.

Part 7 – Calculation of credit risk for securitization exposures

22. This Part prescribes the calculation framework for securitization exposures. Divisions 2 and 3 and Schedules 9 to 13 set out the technical details that a local institution must comply with in using the standardized (securitization) approach to calculate its credit risk for securitization exposures. Divisions 2, 4, 5 and 6 and Schedules 9, 10 and 12 to 14 set out the technical details that an institution must comply with in using the IRB (securitization) approach to calculate its credit risk for securitization exposures. Schedules 9 and 10 set out the criteria that an originating institution in a securitization transaction is required to satisfy before the underlying exposures (in the case of a traditional securitization) or the credit risk of the underlying exposures (in the case of a synthetic securitization) can be considered as removed from the book of the institution.

Part 8 – Calculation of market risk

23. This Part prescribes the calculation framework for market risk positions. Divisions 2 to 10 set out the technical details that a local institution must comply with in using the standardized (market risk) approach to calculate

its market risk. In particular, Divisions 3 to 6 set out the technical details that an institution must comply with for the calculation of the capital charge for its market risk positions in debt securities, interest rates, equities, foreign exchange and commodities. Calculation of the market risk capital charge for an institution's option exposures and credit derivative contracts is set out in Divisions 7 to 10.

24. Divisions 11 and 12 and Schedule 3 set out the technical details that a local institution must comply with in using the internal models approach to calculate its market risk. An institution using this approach is allowed to use its own internal models (mainly using the value-at-risk techniques) to calculate its market risk.

Part 9 – Calculation of operational risk

25. This Part prescribes the calculation framework for operational risk. Division 2 sets out the technical details that a local institution must comply with in using the basic indicator approach to calculate its operational risk. Under this approach, an institution's operational risk capital charge is based on its average gross income over the last three years. Division 3 and Schedule 15 set out the technical details that an institution must comply with in using the standardized (operational risk) approach to calculate its operational risk. Under this approach, an institution's operational risk capital charge is based on the average gross income of eight standardized business lines over the last three years. Division 4 sets out the technical details that an institution must comply with in using the alternative standardized approach to calculate its operational risk. This approach is similar to the standardized (operational risk) approach, except that the capital charge for the standardized business lines of retail banking and commercial banking is calculated by reference to the asset size (loans and advances) of those business lines, rather than gross income.

The Disclosure Rules

26. The Disclosure Rules are divided into eight parts.

Part 1 – Preliminary

Interpretation

27. This Part contains definitions of the terms used generally throughout the Disclosure Rules. Any term or expression used in the Disclosure Rules has the same meaning as assigned to it in the Capital Rules unless otherwise defined in the Disclosure Rules. As such, the Disclosure Rules contain appropriate cross references to the relevant parts of the Capital Rules, and they should be read in conjunction with the Capital Rules to ascertain the meaning of many of the terms or expressions used.

Application

28. Section 3 specifies the AIs to which the various Parts of the Disclosure Rules apply. A local institution will be exempted only if it can meet the criteria specified in section 3(7). Further exemptions in respect of interim reporting are available for an AI which is a wholly owned subsidiary of a local institution and is not listed on the Hong Kong Stock Exchange by virtue of section 3(8). For overseas incorporated AIs, the exemption criteria are specified in section 3(9). In all cases, the exemption criteria mirror the HKMA's existing practice.

Part 2 – General Requirements for AIs Incorporated in Hong Kong

29. This Part specifies the general disclosure requirements applicable to local institutions, including the requirement for a clearly documented disclosure policy approved by the institution's board of directors (section 5) and the requirement that an AI publishes a Disclosure Statement (section 6). Section 6(3) provides an AI with the choice of either publishing a Disclosure Statement that contains all the disclosures required under the rules, or a prescribed summary setting out the location at which and the means by which the general public may readily access all the required disclosures. This Part also specifies the period for which the disclosures should be made, the places at which the Disclosure Statement should be exhibited, and the hours during which the Disclosure Statement should be made available to the general public for inspection.

30. Where similar disclosures are made under accounting or listing requirements, AIs may in accordance with sections 7(d) and (e) rely on them to fulfil the applicable requirements in the rules. An AI is also permitted to rely on disclosures made at the parent level provided that the disclosures have also been prepared according to the Pillar 3 standards and provided that they meet the criteria specified in section 15, in particular by providing a sufficient level of detail about the group's operations in Hong Kong.

31. Section 8 requires the senior management of an AI to ensure that the information disclosed is subject to sufficient scrutiny and is not false or misleading in any material respect. Subject to the prior consent of the MA, section 9 permits an AI to disclose general information as a substitute for that specifically required under the rules should such a disclosure fall within the definition of "proprietary or confidential information" as specified in section 9(2),

32. Section 12 provides that different disclosure requirements will be applied to local institutions depending on which approach they use for the calculation of regulatory capital for credit risk, market risk and operational risk.

Part 3 – Interim Financial Disclosures to be made by AIs Incorporated in Hong

Kong

33. This Part specifies the disclosures a local institution will be required to make in relation to information relating to the institution's interim reporting period.

Part 4 – Annual Financial Disclosures to be made by AIs Incorporated in Hong Kong

34. This Part specifies the disclosures a local institution shall make in respect of every financial year of the institution. Disclosures required under this Part will generally be satisfied by disclosures made under the Hong Kong Financial Reporting Standards.

Part 5 – Additional Annual Disclosures to be made by AI using Standardized Approach to Calculate its Credit Risk for Non-Securitization Exposures

35. This Part specifies the additional disclosures a local institution shall make in respect of its financial year if it uses the standardized (credit risk) approach to calculate its credit risk for non-securitization exposures.

Part 6 – Additional Annual Disclosures to be made by AI using Basic Approach to Calculate its Credit Risk for Non-Securitization Exposures

36. This Part specifies the additional disclosures a local institution is required to make in respect of its financial year if it uses the basic approach to calculate its credit risk for non-securitization exposures.

Part 7 – Additional Annual Disclosures to be made by AI using IRB Approach to Calculate its Credit Risk for Non-Securitization Exposures

37. This Part specifies the additional disclosures a local institution shall make in respect of its financial year if it uses the IRB approach to calculate its credit risk for non-securitization exposures.

Part 8 – Disclosures to be made by AIs Incorporated Outside Hong Kong

38. This Part specifies the disclosures an AI incorporated outside Hong Kong shall make in respect of every financial year and in respect of every six month period immediately after the close of the institution's financial year.

LEGISLATIVE TIMETABLE

39. The Rules were published in the Gazette on 27 October 2006 (see L.N. 228 and 229 of 2006) and will be tabled at the Legislative Council on 1

November 2006 for negative vetting. Subject to the completion of the negative vetting process, it is intended that the Rules should come into operation on 1 January 2007, the same day appointed for the commencement of the Basel II related provisions (i.e. sections 2, 3, 4, and 6 and the Schedule) of the Banking (Amendment) Ordinance 2005 by the Secretary for Financial Services and the Treasury. This is to ensure that the implementation of Basel II in Hong Kong follows the timetable set by the BCBS for its members.

IMPLICATIONS OF THE RULES

40. The Rules are in conformity with the Basic Law, including the provisions concerning human rights. They have no financial, civil service, productivity, environmental or sustainability implications.

41. As will be evident from the contents of the Capital Rules, capital requirements for risks run by local institutions will be more comprehensive and risk-sensitive, which is important for banking stability reasons. Further, by allowing institutions to use their own risk management systems as the basis for the calculation of regulatory capital requirements under the more advanced calculation approaches, the revised capital requirements provide an incentive for institutions to upgrade their own systems, which will enable them to better distinguish the credit quality of borrowers and form better pricing policies. This greater efficiency should be beneficial to the economy. Moreover, the increased attention to risk brought about under Basel II, and the focus on improving risk management, will benefit banking stability, while at the same time facilitating innovation and competition.

42. The enhanced disclosures required under the Disclosure Rules will contribute to supervisory monitoring efforts and stability of banking system. AIs themselves may also benefit from the disclosure, as the ability to demonstrate that they have robust risk management systems might be expected to lead to a stronger ability to access funds, reduced cost of funds, and improved borrowing conditions. To the extent that the market is currently requiring AIs to hold a capital buffer against unforeseen risks, greater transparency should also help demonstrate that these risks have been identified and controlled, thus allowing more efficient allocation of capital.

43. In sum, the adoption of the Rules, which have been developed substantially based on the revised capital adequacy standards set out under Basel II, will contribute to greater robustness of the banking system and greater banking stability. The improvements in risk management necessary to implement Basel II will also stand AIs in good stead for future development of their business, and will contribute to the efficiency and effective working of the banking system.

PUBLIC CONSULTATION

44. In accordance with sections 98A and 60A of the Ordinance, the MA has consulted the BAC, DTCAC, HKAB, DTCA and the FS on the Rules. Apart from these parties specified in the legislation, the HKMA has also specifically sought comments from a broad spectrum of society, including members of the LegCo Panel on Financial Affairs, the Consumer Council, the business community (through trade associations and chambers of commerce), the accounting and legal professions, and academics. For the Disclosure Rules, the HKMA has also consulted interested parties such as credit rating agencies and financial analysts, and members of the Joint Technical Working Group on Financial Disclosure (which includes representatives of both the Hong Kong Stock Exchange and the Securities and Futures Commission). The wide scope of the consultation parties was to ensure broad support and to identify issues of relevance to industry players and the general public so that they could be properly considered before the Rules are finalised.

45. Around 30 sets of responses to the Capital Rules and 20 sets of responses to the Disclosure Rules were received, including responses from the two industry associations. All the respondents were supportive of the objectives of the rule-making, with the comments being mainly requests for clarification on technical points. All comments have been properly addressed. The HKMA has set out its responses to the comments received from the public consultation in a Feedback Statement, which has been posted on the HKMA website and attached at Annex for reference.

PUBLICITY

46. The HKMA will issue a letter to all AIs informing them of the issuance of the Rules. A press release will also be issued on 27 October 2006. A spokesman will be available to answer media and public enquiries.

ENQUIRIES

47. Enquiries on this brief may be directed to Ms Rose Luk, Head (Banking Policy) of the HKMA at 2878 1638.

Hong Kong Monetary Authority
Financial Services and the Treasury Bureau
27 October 2006

Annex

Feedback Statement

Consultation on Banking (Capital) Rules and Banking (Disclosure) Rules

In this Feedback Statement, we respond to the comments we received on the draft Banking (Capital) Rules and Banking (Disclosure) Rules (which are hereafter referred to respectively as “Capital Rules” and “Disclosure Rules”, and collectively as “the Rules”) for the implementation of Basel II in Hong Kong. We released the Capital Rules and Disclosure Rules for public consultation on 3 August and 1 September 2006, respectively.

2. In accordance with sections 98A and 60A of the Banking Ordinance as amended by the Banking (Amendment) Ordinance 2005, the HKMA has consulted the Banking Advisory Committee, Deposit-taking Companies Advisory Committee, the Hong Kong Association of Banks, Deposit-taking Companies Association and the Financial Secretary on the Rules. Apart from these parties specified in the legislation, the HKMA has also specifically sought comments from a broad spectrum of society, including members of the Legislative Council Panel on Financial Affairs, the Consumer Council, the business community (through trade associations and chambers of commerce), the accounting and legal professions, and academics. For the Disclosure Rules, the HKMA has also consulted interested parties such as credit rating agencies and financial analysts, and members of the Joint Technical Working Group on Financial Disclosure (which includes representative of both the Hong Kong Stock Exchange and the Securities and Futures Commission). The wide scope of the consultation parties was to ensure broad support and to identify issues of relevance to industry players and the general public so that they could be properly addressed before the Rules are finalised.

3. Around 30 sets of responses to the Capital Rules and 20 sets of responses to the Disclosure Rules were received, including responses from the two industry associations. We are grateful to all respondents for their submissions. All of the respondents were supportive of the objectives of the rule-making, with the comments being mainly requests for clarification on technical points. The attached summary reports on the main issues raised by the respondents and our feedback to those issues. Comments received are being addressed in the final version of the Rules, where appropriate.

4. It is expected that the final Rules will be published in the Gazette in late October and tabled in the Legislative Council for negative vetting in early November. Subject to the completion of the negative vetting process, it is intended that the Rules should come into operation on 1 January 2007.

5. This Feedback Statement has been published on the HKMA website – www. hkma.gov.hk.

Hong Kong Monetary Authority
October 2006

Statutory Consultation on Banking (Capital) Rules & Banking (Disclosure) Rules
Summary of Responses to Comments Received

Banking (Capital) Rules

	Comments Received (summarised)	HKMA's Response
General		
1.	On the basis that the Banking (Capital) Rules apply to authorized institutions (AIs) incorporated in Hong Kong, the Banking (Capital) Rules should be clarified to that effect.	Section 98(1) of the Banking Ordinance (BO) (Cap 155) requires that an AI incorporated in Hong Kong to have at any time a capital adequacy ratio (CAR) of not less than 8 per cent as calculated in accordance with the provisions of subsection (2) and rules made under section 98A(1) by the Monetary Authority (MA), as amended by section 4 of the Banking (Amendment) Ordinance 2005. Thus, it could be deduced from the wording of section 98(1) of the BO that the Rules would apply to AIs incorporated in Hong Kong.
2.	The draft Rules did not completely address how bank holding companies should calculate and report capital.	Under section 2.24(2) of the Rules, the MA may require the CAR of an AI to be calculated on a consolidated basis in respect of a subsidiary of the institution where the subsidiary satisfies certain criteria. The HKMA has decided not to extend the application of the Rules to a bank holding company for the time being after it has considered the comments from the consultation on the Banking (Amendment) Bill 2005, particularly in view of the lack of consensus among banking regulators as to how exactly Basel II should be implemented. Nevertheless, the HKMA will continue

		to rely on its existing power under the BO in respect of controllers of AIs to require, where necessary, the controller to maintain a minimum CAR based on the calculation methodologies as agreed with such controller on a case by case basis.
3.	Section 98(1) of the BO requires AIs to maintain a CAR of not less than 8% at all times. It is unclear how frequent the Rules require the various amounts to be computed for the calculation of CAR. The Rules as drafted may give an impression of dealing with static positions instead of dynamic positions.	The understanding that section 98(1) of the BO requires AIs to have at all times the requisite CAR is correct. AIs have systems in place to provide assurance that their CAR is maintained at all times at a level above the required minimum. It is the practice for AIs to maintain their CAR at a level above the required minimum, and this "buffer" gives them assurance that the day-to-day fluctuations in their risk-weighted assets and capital base that are a normal part of business will not lead to them breaching the required minimum. If, however, an event takes place that could have a material effect on an AI's CAR – for example the redemption of capital instruments included in its capital base, the acquisition of a substantial portfolio of assets increasing its risk-weighted assets, or a major market upheaval – the AI would need to recalculate the CAR as at that point in time to verify that it remains above the statutory minimum. Hence, we consider that there is no need to state in the Rules how frequent the CAR of an AI should be computed. So far, AIs have not indicated any practical problem in complying with the "at all times" requirement, which is already in place under the existing capital adequacy regime.
4.	The Rules have in different sections required an AI to demonstrate to the satisfaction of the MA various matters or state	The MA will issue guidelines setting out the relevant criteria for implementing provisions where AIs are required to demonstrate

	of affairs without providing for how such demonstration is to be done and what the relevant criteria for the MA's satisfaction are. Clarification is sought on whether the MA will issue guidelines in respect of the implementation of such provisions.	to the MA's satisfaction certain matters or state of affairs where necessary.
5.	Under the IRB approaches, an AI is required under the relevant provisions of the Rules to do things that involve subjective judgements or estimations. It will therefore be difficult to gauge whether the AI has duly complied with the requirements of the Rules. It is also unclear how the MA could effectively check against an elaborate system set up by an AI using IRB approaches, and in particular, errors or falsification in data used.	To address these concerns, the MA has issued a supervisory guideline on "Validating Risk Rating Systems under the IRB Approaches" in February 2006, setting out the MA's approach to the validation of AIs' internal rating systems and the requirements that the MA would expect AIs to follow in order to qualify for using the IRB approaches. To meet the IRB qualifying criteria, among other things, AIs need to demonstrate the effectiveness of their systems and controls in ensuring data quality and the accuracy and reliability of the credit risk components generated from their rating systems based on various techniques and tests acceptable to the MA. We believe that this guideline will provide useful reference to AIs on the validation standards and techniques and ensure the consistent application of these standards and techniques to individual AIs. In addition, an AI using the IRB approach is required to regularly conduct an independent review or audit of its compliance with the minimum requirements set out in Schedule 2.1 of the Rules. The review may be conducted by its internal auditors or by independent external parties which are qualified to do so. This helps ensure AIs using the IRB approach can comply with the requirements of the Rules on a continuing basis.
6.	The terms "regulatory reserve" and "total regulatory reserve" do not appear to have been defined. It is not entirely clear what	The regulatory reserve refers to that part of an AI's reserves that it is required to maintain in order to satisfy section 9 of Schedule

	each comprises of. “Regulatory reserve for general banking risks” does not seem to have been defined in the Rules. Please consider whether the term needs to be defined.	7 to the BO. This makes it an on-going authorization requirement for an AI to maintain adequate provisions "for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur." Since the introduction of new accounting standards in 2005, accountants only require provisions to be made against losses that have already occurred. By contrast both the BO and prudent banking practice requires provisions against losses that might reasonably occur in the future. The regulatory reserve provides a mechanism to make these provisions against potential future losses and since this is specific to the banking industry, the meaning is commonly understood by AIs. The HKMA has issued various guidance / circulars to AIs on the nature and purpose of regulatory reserve.
7.	The term “securities” has not been defined. Hence, when it is part of an undefined description or phrase, e.g. “fixed rate securities” and “floating rate securities” in section 5.6, the scope of such description or phrase may not be sufficiently clear.	The descriptions in relevant sections will be clarified by changing to “fixed rate <u>debt</u> securities” and “floating rate <u>debt</u> securities”. The term “debt securities” is a defined term in Parts 4 and 5 of the Rules (which are the only Parts in which “fixed rate debt securities” and “floating rate debt securities” are referred to).
Part 1 Section 1.2 – Interpretation		
8.	“calendar quarter” – it appears that a period cannot be consecutive. Please clarify whether the word “consecutive” should rather be inserted between “3” and “calendar months”.	The definition will be modified as suggested.

9.	"exchange rate contract" - please clarify whether currency exchange rate linked deposits are intended to be covered. If yes, the definition would require modification.	A currency exchange rate-linked deposit is regarded by the market as a kind of structured product, comprising both derivative and non-derivative elements. An "exchange rate contract", as defined in the Rules, is only intended to include the derivative element of a currency exchange-rate linked deposit, namely the currency option contract (being an exchange rate contract) that is embedded in the deposit. It is not intended to include the non-derivative element (i.e. the deposit itself). The definition of "derivative contract" will be modified to clarify this along the following lines - *"(a) means a financial instrument (other than a bond, loan, share, note or structured financial instrument) the value of which is determined by reference to the value of, or any fluctuation in the value of, one or more than one underlying asset, index, financial instrument, rate or thing as designated in the financial instrument; and* *(b) where a financial instrument which falls within paragraph (a) is embedded in or combined with, or forms part of, a bond, loan, share, note or structured financial instrument, means only the financial instrument which falls within paragraph (a)."*
10.	"external credit assessment institution" – please consider whether it would be more flexible if the list be put in a schedule with power to the MA to amend it by notice published in the Gazette.	The Rules are subordinate legislation which the MA has been delegated the authority to make under section 98A of the BO. As the Rules are subsidiary legislation, they are subject to negative vetting by the Legislative Council (LegCo). In our view, the authority granted to the MA under section 98A does not extend to allowing the MA to give himself the power in the Rules subsequently to amend the Rules simply by notice published in

		the Gazette. Rather, any such amendment to the Rules would itself take the status of subordinate legislation and thereby would also be subject to negative vetting by LegCo, in the same way as the Rules are.
11.	"foreign public sector entity" - the reference to the two Basel Committee documents in paragraphs (a) and (b) respectively has not specified the applicable portion of each document. In view of the considerable length of the documents, it may be difficult to know whether a particular specification by a relevant banking supervisory authority is in accordance with the relevant document.	The reference to the two Basel Committee documents is intended to ensure that the relevant banking supervisory authority has implemented either of the capital adequacy standards based on which it determines the preferential risk-weighting treatment for public sector entities. Specification of public sector entities by a foreign supervisory authority will however be made independent of the two Basel Committee documents. Therefore, specifying which portions of the two documents relate to the preferential treatment does not appear to be necessary.
12.	"forward asset purchase" – please clarify whether the definition is intended to cover daily retail banking activities of an AI. The definition as drafted could catch retail agreements of currency exchange by which an AI has committed to purchase from a depositor an amount of currency at a prefixed exchange rate.	Forward exchange rate contracts are not caught under this definition but are instead caught under the definition of "exchange rate contracts". We will modify the definition of "forward asset purchase" to improve clarity.
13.	"specific provisions" – the definition does not seem to help one to find out what they are or to arrive at an amount.	The term is familiar to AIs since it has been used throughout our circulars, supervisory policy manual and regulatory returns etc. There is no need to explain how an AI's specific provisions are to be derived, as they are determined based on the AI's assessment of the impairment loss of its credit risk exposures on a case by case basis (as the definition indicates).

14.	“securities firm” – this definition should be clarified as to whether it includes a banking or deposit-taking institution that conducts securities business (e.g. a registered institution as defined in the Securities and Futures Ordinance, or an equivalent institution overseas).	The HKMA will make this clear by excluding "bank" from the definition of "securities firm".
Part 2 – Prescribed approaches in relation to calculation of capital adequacy ratio		
15.	The MA has power to refuse an application made by an AI under any one of the relevant provisions in this Part. This power appears to be discretionary and unrestricted. There is also no obligation to give any reason for a refusal. The provisions may be unfair to the AI.	In practice, the HKMA always gives reasons for refusing an application made by an AI. In respect of the Rules, the main applications that the MA will have to decide relate to the approaches an AI wishes to use to calculate its exposures, as set out in sections 2.3, 2.5, 2.15 or 2.18. The principal criteria on which a decision to refuse an application will be based are referred to in each of these sections. Moreover, under section 2.31, if any AI is aggrieved by the MA’s decision made under sections 2.3(2), 2.5(2), 2.15(2) or 2.18(2), it may, under section 101B of the BO, apply to the Capital Adequacy Review Tribunal to review that decision. In determining that review, the Tribunal will be provided with all papers relevant to the decision in the possession of the MA, both the aggrieved AI and the MA will have the opportunity to be heard, and the Tribunal will deliver its decision and the reasons for its decision as soon as practicable after completing its review (section 101C of the BO). Further, under section 101E of the BO the Tribunal is given various powers to receive and consider evidence for the purpose of determining its review.

16.	<u>**Section 2.7 – Measures which may be taken by Monetary Authority if authorized institution using BSC approach or IRB approach no longer satisfies specified requirements**</u> In subsections (2) and (5), reference is made to credit risk for non-securitization exposures in respect of "all of its business" or "such part of its business as specified in the notice". It is noted in sections 2.2, 2.3, 2.5 and 2.6, references have been made to "credit risk for non-securitization exposures" only. It may be more logical and consistent to refer to "all its non-securitization exposures" and "such part of its non-securitization exposures as specified in the notice" instead of the undefined and difficult to be precisely defined term "business". Also the present drafting may restrict the ways in which the MA may limit the scope of its notice to that of referring to the business of an AI only.	 We agree with the comment and will amend section 2.7 along the following line: Subsection (5)(a) will be revised as follows - *"(a) the Monetary Authority may, by notice in writing…instead of the IRB approach in respect of <u>all of its</u> ~~business~~ <u>non-securitization exposures</u>, or such <u>parts of its</u> ~~business~~ <u>non-securitization exposures</u> as specified in the notice,…* Similar changes will also be made to subsection (2).
17.	<u>**Section 2.9 – Exemption for exposures**</u> (i) The proposed "sub-limit" of 5% for an IRB class (or, in the case of retail exposures, an IRB subclass) of non-equity exposures (i.e. corporate, bank, sovereign and retail exposures) may impose unnecessary restrictions on AIs which will lose the flexibility to expand a specific portfolio or develop a new product according to its own business needs. In order to provide AIs with more flexibility for their business needs, it is suggested that the aforesaid "sub-limit" should be revised from 5% to 10%.	 (i) The 5% sub-limit is intended to ensure that exemption from application of the IRB approach confines only to credit risk portfolios that are not of a material size. Having regard to the industry concern, however, we agree to revise this sub-limit from 5% to 10% to provide more flexibility for AIs to manage their exempted portfolios. Section 2.9(4)(b)(i) will be revised accordingly. Some flexibility will also be provided in section 2.10 for AIs which fail to comply with this sub-limit on a temporary basis

	(ii) <u>Subsection (5)</u> An AI which uses the IRB approach to calculate its credit risk for non-securitization exposures may apply to the MA to have part of its non-securitization exposures exempted from inclusion in the IRB calculation. The AI is required to satisfy prescribed substantive criteria in order to be eligible for exemption. On top of that, section 2.9(5) gives the MA the power to refuse to grant exemption if it is satisfied that the AI can use the IRB approach to calculate its credit risk for the relevant exposures without incurring significant cost or expending significant resources. The regulatory rationale of this subsection is, however, questionable since exemption will only be granted when the MA is satisfied that it will not prejudice the AI's calculation of credit risk and the effectiveness of the IRB approach.	(see item 18 below). (ii)Under the Basel II framework, once a bank adopts an IRB approach, the ultimate objective is for the bank to extend the use of the IRB approach across the entire bank (and, where applicable, the entire banking group). To be eligible for the use of the IRB approach, a bank must produce a realistic implementation plan, specifying to what extent and when it intends to roll out the IRB approach across significant asset classes and business units over time. The plan should be driven by the <u>practicality and feasibility</u> of moving to the IRB approach, and <u>not motivated by a desire to stay on a simpler approach under Pillar 1 that minimises its capital requirements</u>. Based on these broad Basel II principles, we consider it necessary to maintain the requirement under section 2.9(5) to prohibit an AI from deliberately not using the IRB approach (probably for regulatory capital arbitrage purposes) for such exposures to which the AI has no practical difficulty in applying the IRB approach. To better reflect the regulatory intent, however, it is proposed that subsection (5) be deleted and be combined with subsection (2)(a) along the following line - *"if the institution demonstrates to the satisfaction of the Monetary Authority that -*

		(iii) it is not practicable for the institution to include the exposures referred to in subparagraph (i) or (ii), as the case may be, in the relevant calculation; and *(iv) the exemption will not materially prejudice the calculation of the institution's regulatory capital for credit risk; or"*
18.	**<u>Section 2.10 – Revocation of exemption under section 2.9</u>** <u>Subsection (3)</u> The MA is empowered to revoke the exemption granted under section 2.9 if the AI fails to satisfy the exemption criteria at any time after exemption is granted. According to section 2.10(1)(c), the MA may also require the AI to submit a remedial plan to the satisfaction of the MA and implement the plan. If the MA so requires, the AI must submit and implement the plan. However, notwithstanding that the AI has done so, section 2.10(3) provides that the MA is still entitled to exercise its power to revoke the exemption. It is therefore considered that section 2.10(3) should be qualified to the effect that the MA will not exercise its power to revoke the exemption unless the AI fails to implement the remedial plan or the anticipated effect of the remedial plan is not achieved. Otherwise, the AI should be given the option of accepting revocation of the exemption without pursuing remedial action.	<u>Subsection (3)</u> Section 2.10(4) is to address certain situations in which the MA will need such power to revoke an AI's exemption. For example, these include the following situations – • because of the AI's successful implementation of the plan under the renumbered subsection (2)(a), the exemption under section 2.9(2)(a) is no longer required and should be revoked; • the AI concerned may have incurred another breach under section 2.9 while implementing a plan to rectify the first breach. Multiple breaches may warrant the MA to revoke the AI's exemption without delay. It is therefore considered necessary to reserve the MA's power to revoke exemption under section 2.10(4). We will, however, add a new subsection (2)(b) to provide some flexibility to an AI which has breached section 2.9(4) on a temporary basis.

		Section 2.10 will be revised along the following lines - *"(1) Where -* *(a) …* *(b) …the exemption would be refused by virtue of section 2.9(2)~~(b),~~ or (4)~~ or (5)~~,* *the Monetary Authority may take one or more of the measures set out in subsection (2).* *(2) The measures referred to in subsection (1) are that –* *(a) if the fresh application referred to in subsection (1)(b) would be refused by virtue of section 2.9(2), the Monetary Authority may, by notice in writing given to the institution, require the institution to -* *(i) submit to the Monetary Authority a plan, within such period (being a period reasonable in all the circumstances of the case) as specified in the notice, which satisfies the Monetary Authority that, if it were implemented by the institution, the institution would be able to use the IRB approach to calculate its credit risk for those non-securitization exposures within a period which is reasonable in all the circumstances of the case; and* *(ii) implement the plan;* *(b) if the fresh application referred to in subsection(1)(b) would*

		be refused by virtue of section 2.9(4), the Monetary Authority may, by notice in writing given to the institution, require the institution to – *(i) submit to the Monetary Authority a plan, within such period (being a period reasonable in all the circumstances of the case) as specified in the notice, which satisfies the Monetary Authority that, if it were implemented by the institution within a period which is reasonable in all the circumstances of the case, the fresh application would then not be refused; and* *(ii) implement the plan; and* *(c) the Monetary Authority may, by notice in writing given to the institution, revoke the exemption on such date, or the occurrence of such event, as specified in the notice.* *(3) An authorized institution shall comply with the requirements of a notice given to it under subsection (2)(a) or (b).* *(4) For the avoidance of doubt, it is hereby declared that an authorized institution's compliance with a requirement referred to in subsection (2)(a) or (b) does not prejudice the generality of the Monetary Authority's power under subsection (2)(c).*"
	Subsection (1) Does the MA intend the powers under paragraphs (c) and (d) to be exercisable concurrently and not merely as alternative to each other? According to the local drafting convention, the word "or" at the end of paragraph (c) may be dispensed with.	Subsection (1) Taking into account the above proposed changes to section 2.10, the word "and" will be added to the end of subsection (2)(b).

19.	**<u>Section 2.11(1) – Transitional arrangements</u>** Please clarify whether this section overrides Part 6 only during the transitional period or at all times so far as the relevant AI is concerned.	The transitional data requirements will apply to AIs which uses the IRB approach to calculate its credit risk for non-securitization exposures during the transitional period and the 2 subsequent years of 2010 and 2011 in which the transitional data requirement of 3 and 4 years will respectively apply. Section 2.11(1) and Table 2.1 will be modified accordingly to clarify our regulatory intent - Section 2.11(1) will be revised as follows – *"(1) Subject to subsection (2), an authorized institution which ~~commences using~~ <u>uses</u> the IRB approach to calculate its credit risk for non-securitization exposures during the ~~transitional~~ period <u>from 1 January 2007 to 31 December 2011, both days inclusive,</u> may comply with this section instead of Part 6..."* The third column of Table 2.1 will be revised as follows - *2 years during the transitional period~~, increasing by 1 year for each of 2010, 2011 and 2012~~* *<u>3 years for 2010</u>* *<u>4 years for 2011</u>* *2 years during the transitional period~~, increasing by 1 year for each of 2010, 2011 and 2012~~* *<u>3 years for 2010</u>* *<u>4 years for 2011</u>*

20.	**<u>Section 2.12(2)(c) – Authorized institution shall only use STC(S) approach or IRB(S) approach to calculate its credit risk for securitization exposures</u>** Please clarify how an AI would be allowed to use more than one approach to calculate its credit risks.	 As indicated in section 2.2(2), an AI is not prevented from using any combination of the STC approach, BSC approach and IRB approach to calculate its credit risk for non-securitization exposures if that combination is expressly permitted by, and in accordance with, another section of the Rules. For example – • <u>Section 2.3(4)(a)</u> – if an AI is granted approval under section 2.3(2)(a) to use the BSC approach on the ground specified in section 2.4(b) (i.e. it is reasonably likely for the AI to be able to implement the plan to use the IRB approach during the transitional period), the AI may, with the MA's prior consent, use a combination of the STC approach and BSC approach before the IRB approach is adopted during the transitional period; and • <u>Section 2.9(3)</u> – if an AI is granted exemption under section 2.9(2)(a) from applying the IRB approach to certain non-securitization exposures, the AI will be allowed to use the STC approach to calculate its credit risk for those exposures.
21.	**<u>Section 2.22(2)(b)(ii) – Exemption from section 2.17</u>** Reference is made to "current profit and loss". However, it seems logical that only current profit should be deducted.	 As it is possible for an AI to have a loss instead of a profit for a particular financial year, we will change the term "current profit <u>and</u> loss" to "current year's profit <u>or</u> loss" to clarify the meaning.

		In the event that an AI has incurred a loss in the current year, the amount to be deducted (i.e. the current year's loss) will automatically become an addition to the AI's total on-balance sheet and off-balance sheet exposures. Section 2.22(2)(b)(ii) will be revised accordingly.
22.	**<u>Section 2.24 – Authorized institution shall calculate its capital adequacy ratio on a solo basis, solo-consolidated basis or consolidated basis.</u>** Sub-section (1)(b) requires that an "authorized institution shall calculate its capital adequacy ratio on a consolidated basis". However, sub-section (2) states that the MA <u>may</u> require consolidation of subsidiary. Clarification is sought on whether consolidation of subsidiaries is only allowed with HKMA's approval.	Section 2.24 has to be read in the context of the definitions of "consolidated basis" and "consolidation group" in section 2.1, and in the context of section 2.28 which sets out how the "consolidated basis" calculation should be carried out. These sections, when read together, provide that the only subsidiaries to be included in an AI's consolidation group for the purpose of calculating its CAR on a consolidated basis, are those subsidiaries which the MA has specified in a section 98(2) notice to the AI. In deciding whether or not to include a subsidiary in such a notice the MA can take into account the criteria in section 2.24(2).
Part 3 – Determination of capital base		
23.	**<u>Section 3.2 – Determination of capital base</u>** If an AI's supplementary capital exceeds its core capital, would the whole amount of the supplementary capital be ignored or only the portion of the supplementary capital that equals the amount of the core capital may be added to form the capital	Our policy intent is that if an AI's supplementary capital exceeds its core capital, only the portion of the supplementary capital may be included in the capital base (i.e. the AI has to ignore the excess amount). We will clarify in section 3.2(2) that the part of

	base? If the latter is intended, it appears that the drafting should make this explicit.	supplementary capital in excess shall be disregarded for the purposes of calculating the capital base.
24.	**<u>Section 3.3(4) – Essential characteristics of core capital and supplementary capital</u>** This provision makes consultation with the MA mandatory before the issue of any capital instrument other than ordinary shares. Please clarify whether such consultation may be dispensed with if the purpose of issuing capital instruments is not to boost its core or supplementary capital for the purposes of the BO or the Rules.	In practice, the HKMA expects an AI to consult it whenever the institution wishes to issue any capital instrument other than ordinary shares. In our experience it is very rare for an AI to issue such capital instruments without the intention of altering its capital base. Logistically, the consultation is not an onerous requirement as the issuance of such capital instruments is relatively infrequent (and the HKMA conduct the consultation as expeditiously as is reasonably practicable). Further, the consultation provides the AI with certainty as to whether the capital instruments being issued can count as capital, and if so, as which category of capital (core or supplementary).
25.	**<u>Sections 3.4(e) & 3.8(1)(b)(ii) – Core Capital & Supplementary Capital</u>** Clarification is sought as to whether the part of an AI's reserves attributable to fair value gains arising from the AI's holding of equities and debt securities is to be included as the AI's core capital or supplementary capital.	Pursuant to section 3.6(2) in relation to section 3.4(e), an AI is permitted to recognize any unrealised fair value gains arising from its holding of equities and debt securities designated at fair value through profit or loss in its core capital, subject to obtaining prior approval from the HKMA. In considering any application for approval from AIs, an AI is required to demonstrate to the satisfaction of the HKMA that it meets the minimum prudential control standards as specified by

		the HKMA. The HKMA intends to provide AIs with further guidance on the minimum risk management and controls standards relevant to the use of fair value option in Q4 2006; this guidance will be closely modelled on that already issued by the Basel Committee. In the event that an AI fails to satisfy the HKMA that it meets the prescribed minimum prudential standards pertaining to the use of the fair value option, the AI shall exclude any unrealised fair value gains arising from its holding of equities and debt securities designated at fair value through profit or loss from its core capital and include such unrealised fair value gains in supplementary capital, subject to a 55% haircut pursuant to section 3.8.1(b)(ii) of Part 3 of the Rules.
26.	**<u>Section 3.8(1)(i) - Supplementary Capital</u>** Guidance is sought on the treatment of minority interest items other than paid-up irredeemable cumulative preference shares and paid-up term preference shares of an AI's subsidiaries specified in section 3.8(1)(i).	Pursuant to section 3.4(f), an AI shall include in its core capital minority interests in the equity of the AI's subsidiaries arising from a consolidation requirement except any such minority interests which are not freely transferable to – (i) the AI; or (ii) members of the group of companies of which the AI is a member, after taking into account any relevant regulatory, legal or taxation constrains on the transfer of capital. Section 3.7 further provides that where the minority interests arise on consolidation in the paid-up irredeemable non-cumulative preference shares of the AI's subsidiaries which

		are special purpose vehicle (SPV), that part of the AI's core capital shall not exceed 15% of the AI's core capital (including such minority interests) in total. If the amount of the paid-up irredeemable non-cumulative preference shares of the AI's subsidiaries which are SPVs exceed the amount permitted for inclusion (i.e. 15% as referred to in the above paragraph) in the AI's core capital, then any excess amount shall be included in the AI's supplementary capital for capital adequacy purposes pursuant to section 3.8(1)(i). Irrespective of whether the minority interests are included in core capital or supplementary capital, the amount to be included shall be net of any dividend proposed or declared by the AI's subsidiaries.
27.	**<u>Section 3.8(1)(a) & (b) – Supplementary Capital</u>** Since AIs often have subsidiaries holding land and property, equity, and debt securities as trustees or nominees for clients, please confirm that such holdings will not be counted under the present provision.	 Assets held by an AI as trustees or nominees for clients are not regarded as the AI's own assets. Hence they will not be recognized in the AI's balance sheet or form part of the AI's reserves (the inclusion in which is pre-requisite to the application of section 3.8(1)(a) and 3.8(1)(b)). Thus, such holdings will not be counted under the present provisions.
28.	**<u>Section 3.8(1)(b) and 3.10(1) – Supplementary Capital</u>** Fair value gains arising from the revaluation of AI's holding of equities and debt securities not held for trading purposes are	 Pursuant to section 3.10(2)(a), an AI is required to deduct from its core capital cumulative unrealised losses arising from the AI's

	subject to a haircut of 55% in accordance with section 3.10(1). Confirmation is sought on whether any revaluation losses arising from the AI's holdings of equities and debt securities not held for trading purposes should be deducted from capital base. In addition, whether the fair value gains and revaluation losses be assessed at portfolio basis (say equity portfolio) or individual securities basis.	holdings of equities and debt securities not held for trading purposes which fall below the cost of those securities. We confirm that fair value gains on revaluation of holding of securities not held for trading purposes should be applied on a "portfolio" basis.
29.	**<u>Section 3.8(1)(b)(i), 3.10(2)(a)(i)(A) and 3.10(2)(a)(ii)</u>** Please clarify that the words "equities and debt securities not held for trading purposes" as mentioned in sections 3.8(1)(b)(i), 3.10(2)(a)(i)(A) and 3.10(2)(a)(ii) is referring to "available-for-sale equities and debt securities".	 To improve clarity, we will replace the words "equities and debt securities not held for trading purposes" in sections 3.8(1)(b)(i), 3.10(2)(a)(i)(A) and 3.10(2)(a)(ii) by "available-for-sale equities and debt securities".
30.	**<u>Section 3.9(1) – Provisions supplementary to section 3.8(1)(a)</u>** The wording "an authorized institution's reserve shall not fall within that part of the reserve referred to in section 3.8(1)(a)" may be misleading because it would provoke the question which part of the reserve would it fall within. The legislative intent appears rather to be that unless the stipulated conditions are satisfied the amount that could be counted as part of the reserve by virtue of section 3.8(1)(a) will not be so counted at all. It seems that some modification may be required to make this explicit.	 It is our policy intent that an AI needs to meet the stipulated conditions set out in section 3.9(1) in order for that part of the reserves of the AI to be included in supplementary capital pursuant to section 3.8(1)(a). To improve clarity, we will add a subsection in section 3.2 to clarify that any capital which is not included in an AI's supplementary capital by virtue of sections 3.9, 3.10, 3.11 or 3.12 shall not be included in the AI's core capital.
31.	**<u>Section 3.10(3) – Provisions supplementary to section 3.8(1)(b)</u>**	

	Given that any overall deficit for equities and debt securities designated at fair value through profit or loss falling within section 3.8(1)(b)(ii) should have been reflected in the profit or loss account (and hence reflect a deduction from core capital), please clarify whether the overall deficit as referred to in section 3.10(3) which requires to be deducted from supplementary capital is applicable to equities and debt securities falling within section 3.8(1)(b)(i) only.	To improve clarity, we will replace the reference to section 3.8(1)(b) by section 3.8(1)(b)(i) in section 3.10(3).
32.	**<u>Section 3.14(1)(a) - Deductions from Core Capital and Supplementary Capital</u>** It is not clear how goodwill relating to an AI's holdings of shares and other capital regulatory instruments may be determined and quantified.	It is our policy intent to require an AI to deduct from its core capital the amount of the AI's goodwill. We will improve the clarity of section 3.14(1)(a) by removing the sub-paragraph (i) and (ii) in that section. We will also make it clear that the amounts of each holding of shares required to be deducted from core capital and supplementary capital under section 3.14(2) shall be net of any goodwill relating to the respective holdings of shares deducted in accordance with section 3.14(1)(a). In addition, we will remove the words "reported as at the calendar quarter end date" from section 3.14(1)(a) to reflect our policy intent that an AI is required to maintain its capital adequacy ratio in accordance with the Banking (Capital) Rules on a continuous basis rather than only on the reported calendar quarter end. This amendment will also be applied to sections 3.14(1)(b) and (c) based on the same consideration.

33.	**<u>Section 3.14(1)(c) – Deductions from Core Capital and Supplementary Capital</u>** It is provided that the amount of net deferred tax assets is to be deducted from the core capital. It follows that there should be corresponding provisions to cater for the situation where an AI has a net deferred tax liability. To align with the treatment of revaluation surplus, it was proposed that the deferred tax charge, which is equivalent to the amount being deducted from the risk-weighted assets (i.e. revaluation surplus at reporting date less the surplus at 31 December 1998), times the applicable tax rate be added back to the core capital. It is also provided that an AI should deduct from its core capital the amount of net deferred tax assets. Does it refer to the net amount of deferred tax assets after subtracting deferred tax liabilities or only the amount of deferred tax assets before netting any deferred tax liabilities?	 In view of the fact that net deferred tax liability is not readily available to absorb losses, the HKMA believes its policy on this matter is justified. This also explains why there is no provision in the Rules to this effect. We refer to the net amount of deferred tax assets after subtracting deferred tax liabilities.
Part 4 – Calculation of credit risk for non-securitization exposures : STC approach		
34.	**<u>Schedule 4.2 – Standard supervisory haircuts for comprehensive approach to treatment of recognized collateral : Part 3</u>** Clarification is required on the collateral types the haircut of 25% for “Exposures not specified in this table” can be applied to.	 “Exposures not specified in this table” is intended to be a “catch-all item” for exposures not elsewhere specified in the table, if any. Exposures included in this item need not necessarily be in the form of recognized collateral.

35.	**<u>Section 4.7 – Exceptions to section 4.6</u>** Clarification is needed on whether subsection (2)(b) applies only to those countries that have adopted the Basel II framework. In addition, whether AIs have the choice to apply subsection 2(b) or derive the risk weighting based on the external rating of the issuer using the requirements set out in section 4.6. Should subsection (3) be applied to exposure to sovereigns that are located in jurisdictions that are either not following BIS rules or have not yet adopted Basel 2?	 The understanding that section 4.7(2)(b) applies only to jurisdictions that have adopted the Basel II framework is correct. Subsection (2) is concessionary in nature and whether to apply it or not is an option for AIs. Subsection (3) sets out the concessionary treatments that AIs may at their option make use of in case they have exposures to the sovereign of a jurisdiction which has not yet adopted Basel II.
36.	**<u>Section 4.8 – Public sector entity exposures</u>** <u>Subsection (1)</u> Paragraphs (b) and (c) of subsection (1) as presently drafted do not appear to connect well to what goes before. Please consider making paragraph (b) subparagraph (ii) of paragraph (a) and the existing paragraph (a) paragraph (a)(i) with all necessary modifications. Since domestic public sector entities mean a public sector entity specified in Part 1 of Schedule 1.1, the Government must consequently be the Government of HKSAR. When that is so, it is not clear how the situation described in paragraph (c) could arise. <u>Subsection (2)</u> As presently drafted, paragraph (ii) does not connect directly to subsection (2)(a). "And" may be preferable than "or" to serve as the connector between paragraphs (i) and (ii).	 <u>Subsection (1)</u> Paragraphs (a) and (b) of section 4.8(1) will be combined. This is to cater for the possibility, however unlikely, that the Government ceases to have any ECAI issuer rating, or that an AI has nominated for risk-weighting purposes only ECAIs that have not themselves assigned any issuer rating to the Government. <u>Subsection (2)</u> Subparagraphs (i) and (ii) of section 4.8(2)(a) will be combined, but the use of "or" at the end of the present section 4.8(2)(a)(i) is considered appropriate.

	<u>Subsection (2)(c)</u> Section 4.8(2) provides for the allocation of risk-weight to a public sector entity by reference to the credit quality grade applicable to the sovereign of the place of incorporation of that entity. Section 4.8(2)(c) specifically refers to a credit quality grade 5 allocated to a sovereign on the basis of an ECAI issuer rating assigned to the sovereign which will translate into a risk-weight of 100%. Given that both a credit quality grade 5 and a credit quality grade 4 on a sovereign based on an ECAI issuer rating will translate into the same risk-weight of 100%, please clarify whether section 4.8(2)(c) should refer to both credit quality grades 4 and 5.	<u>Subsection (2)(c)</u> The observation is correct and we will rectify the error accordingly.
37.	<u>**Table 4.10 – Determination of CCF for OTC derivative transactions or credit derivative contracts**</u> Clarification is sought as to whether the current exemptions (such as instruments traded on exchange or margin trading transactions which are subject to daily margining requirements) under Basel I would apply under Basel II.	As indicated in the definition for the term "over-the-counter derivative transaction" in the Rules, any exchange rate contract, interest rate contract, equity contract, precious metal contract or other commodity contract that is (i) traded on an exchange AND (ii) subject to daily re-margining requirements is to be exempted from capital requirement.
38.	<u>**Section 4.14(a) & (e) – Cash items**</u> It is not clear how the attributed risk-weight of the person or the obligor is to be ascertained.	"Attributed risk-weight" is a defined term under Section 4.2. As such, the "attributed risk-weight of the person" in section 4.14(a) and the "attributed risk-weight of the obligor" in section 4.14(e) are determined by reference to whichever of sections 4.6 to 4.12, 4.15, 4.17 or 4.18 would apply to such person or obligor based on

		the mechanism described in the definition of "attributed risk-weight". So, for example, if the person who holds the gold bullion for the purposes of section 4.14(a) is a corporate, then the risk weight is determined by reference to section 4.12 (which applies to corporate exposures). Accordingly, given the context in which "attributed risk-weight of the person" and "attributed risk-weight of the obligor" are used in section 4.14, we consider the method of determination is sufficiently clear.
39.	**<u>Section 4.15 (2)(b)(i) – Regulatory retail exposures</u>** Clarification is required on whether mortgages risk weighted at 35% and 75% should be excluded from the calculation of the maximum aggregate exposure. Is it correct to interpret that only those mortgages risk weighted at 35% should be excluded? If mortgages risk weighted at 75% are excluded how will section 4.16 (9) be applied?	 For the purpose of calculating the maximum aggregate exposure, the following should be excluded as far as any residential mortgage loan is concerned: • a loan which is eligible for 35% risk-weight; • a loan that would have been eligible for 75% risk-weight if the maximum aggregate exposure to the borrower, including the loan, had not exceeded $10 million (in which case the loan shall be risk-weighted at 100%). Sections 4.15(2)(b)(i) and 4.16(9) will be revised to make the above clearer.
40.	**<u>Section 4.16 – Residential mortgage loans</u>** <u>Section 4.16(1)(c)</u> This subsection is meant to qualify the reference to "each residential property" in paragraph (b). It seems unnatural to refer to such residential property as "falls within" paragraph (b).	 <u>Section 4.16(1)(c)</u> The meaning of "each residential property <u>which falls within</u> paragraph (b)" in section 4.16(c) is sufficiently clear. The approach adopted is not uncommon in the statute.

	It may be preferable to substitute the two words with "is charged under a first legal charge as a security for the loan referred to in".	
	Section 4.16(1)(e) There may be a surplus of words in the paragraph. It seems more logical to state that the loan-to-value ratio does not exceed 100% at the drawdown or that the loan does not exceed the current market value of the property.	Section 4.16(1)(e) The section is intended to be a continuing requirement for ensuring that the loan remains fully secured (i.e. a loan-to-value ratio of not more than 100% based on loan outstanding and current market value of mortgage property) any time after it becomes an on-balance sheet exposure (either through drawdown of a loan commitment or purchase of a loan from a third party). Section 4.16(1)(e) will be refined to make it clear that it is the loan-to-value ratio which does not exceed 100%.
	Is it acceptable for an AI for the time being not to keep the latest market value, as the case may be, for some properties until systems for maintenance of latest market information are in good place?	Whether the preferential risk weight of 35% is applicable to a residential mortgage loan (RML) depends on, among other things, an AI knowing the current market value of residential mortgage property in respect of the loan. The HKMA considers that as part of its prudent credit risk management policy for RMLs (particularly if these represent a significant portfolio in its loan book), an AI should generally have an adequate system in place to enable a reasonable estimate of the current market values of residential mortgage properties.
	Section 4.16(6)(b)(ii) It may be preferable to specify the nature of insurance as most borrower of a residential mortgage loan is required to take out fire insurance covering the whole amount of the mortgage loan.	Section 4.16(6)(b)(ii) We will change the term "insurance" in the section to "mortgage guarantee insurance", a term used by the Office of Commissioner of Insurance to describe insurance protecting the lending bank against risk of loss arising from the default in payment by the mortgagor in respect of insured portion of the loan.

	<u>Section 4.16(5)</u> It is indicated that the requirement under section 4.16(1)(d) is waived if the mortgage loan was made prior to 1 January 2007. Does that then mean that a residential mortgage extended by a bank prior to 1 January 2007 that complies with 4.16(1) except for the fact that at the time the mortgage loan was made, the original loan to original value exceed 70%, such mortgage would be risk-weighted at 35%? <u>Section 4.16(9)</u> It is not clear how the excluded loan is to be dealt with in the context of the calculation of credit risks.	<u>Section 4.16(5)</u> The intention of Section 4.16(5) is to minimize excessive administrative burden on AIs having to dig out records to ascertain the original loan-to-value ratio of residential mortgage loans granted a long time ago. This concessionary provision relies on the strength of the existing 70% lending guideline which has already been in place for some 15 years, and most of the residential mortgage loans outstanding in the banking industry should therefore have met the original loan-to-value ratio of 70% and will be qualified for the 35% risk weights providing other relevant criteria are satisfied. <u>Section 4.16(9)</u> The excluded loan will be subject to section 4.16(4)(b) and be risk-weighted at 100%. We will make this clear in re-drafting section 4.16(9).
41.	**<u>Section 4.20 – Application of ECAI ratings</u>** In the third last line of the subsection (3) (and the last line of section 4.20(4)), the word "it" should perhaps be replaced by "him" as the context appears to suggest that the "debt obligation" is issued or undertaken by "the person".	 To avoid confusion, the pronoun "it" will be replaced by "the person" which includes any body of persons, corporate or unincorporated (Cap 1).
42.	**<u>Section 4.43 –Adjustment of standard supervisory haircuts in certain circumstances</u>** Where the collateral for certain types of transactions like the following is not regularly remargined or revalued, please clarify	 For the first type of transactions, the remargining frequency may be taken as the number of days remaining until the deal matures.

	what should be taken as the actual remargining / revaluation frequency for the purposes of adjusting the standard supervisory haircuts: 1. Repo-style transactions that are not re-margined (probably because they are short-dated); 2. Repo-style and other capital market transactions that are revalued daily but remargined only when the value of collateral has fallen below a certain threshold in comparison with the value of exposure.	For the second type of transactions, the remargining frequency may be taken as the revaluation frequency providing, where remargining is considered necessary based on a revaluation of the value of exposure and the value of collateral on a particular day, the remargining is done on the same day.
Part 5 – Calculation of credit risk for non-securitization exposures : BSC approach		
43.	**<u>Section 5.12(1)(c) – Residential mortgage loans</u>** It is not unusual that a borrower would acquire a residential property to be used as a residence for his or her parents or immediate family members. Such cases appear to have been excluded by the present drafting.	 In order not to preclude loans secured by residential mortgage property used in the like manner from being eligible for the preferential risk-weighting treatment, we propose to add "or intended for use" after "use" in the 1st line and "or a licensee" after "tenant" in the last line of section 5.12(c)(i) and (ii). The same applies to section 4.16(c)(i) and (ii).
44.	**<u>Section 5.30(2) & (3) – Recognized credit derivative contracts</u>** The term "restructuring" is not defined in the Rules. Although it has a specific meaning in the parlance relating to derivative transactions, please consider whether there is need to provide a definition.	 "Restructuring" for the purposes of these sections, is explained in section 5.30(1)(k)(iii), which reads as follows "*subject to subsections (2) and (3), the protected exposure is restructured, involving forgiveness or postponement of payment of any principal or interest or fees, which results in the institution making any deduction or specific provision or other similar debit*

		to the institution's profit and loss account". Since section 5.30(1)(k)(iii) is specifically made subject to sections 5.30(2) and 5.30(3), we consider that the term "restructuring" as it appears in these latter two sections has been sufficiently clear and, accordingly, there is no need separately to define it.
Part 6 – Calculation of credit risk for non-securitization exposures : IRB approach		
45.	**<u>Section 6.7 – Retail exposures</u>** Under section 6.7(3), only residential mortgage loans can be treated as "residential mortgages". This deviates from the Basel II requirements which also include revolving credits.	 Section 6.7(3) should read in conjunction with the definition of "residential mortgage loan" provided in Part 1. In fact, this term is defined as "*a <u>credit facility</u> provided by the institution to a borrower……*". We therefore believe that the current drafting of section 6.7(3) should be broad enough to include revolving credits and overdraft facilities.
46.	**<u>Section 6.23 - Loss given default under foundation IRB approach</u>** Clarification is sought on whether collateral held against OTC derivative contracts should be recognized as an adjustment to EAD (credit equivalent amount) or as an adjustment to LGD using Formula 6.3.	 The capital treatment for recognition of collateral in respect of an exposure under the IRB approach is through the determination of the LGD for the exposure. The E* (i.e. net credit exposure) under Formula 6.3 is used <u>only</u> to calculate the effective LGD of an exposure covered by recognized financial collateral. An AI using the IRB approach must continue to calculate EAD without taking into account the presence of any collateral.
47.	**<u>Section 6.23 – Loss given default under foundation IRB approach : Formula 6.4</u>**	

	Clarification is sought on when the haircut "H_e" will be applied in the calculation. It is assumed that an AI will only apply "H_e" to repo-style transactions under which the exposure to the counterparty is in the form of securities pledged.	The haircut "H_e" is applicable to an exposure covered by recognized financial collateral when determining an AI's effective LGD under the foundation IRB approach. In most cases, the value of this haircut will be zero because the exposures will usually be in the form of loans. It is thus correct to assume that such haircut will be applied only when the exposure to the counterparty is in the form of securities lent or pledged.
48.	**Section 6.89 – Calculation of capital floor** Section 6.89(3) and (5) sets out the calculation of the capital floor for an AI which starts to use the IRB approach during and after the transition period. Please clarify why section 6.89(3) excludes the risk-weighted amount for operational risk while section 6.89(5) includes the risk-weighted amount for such risk.	 According to the Basel II framework, the capital floor is based on the application of the Basel I which takes **no** account of operational risk. The HKMA, therefore, applies the same concept to AIs which commence the use of the IRB approach during the transitional period. However, from 2010 onwards, it is considered more appropriate for AIs (i.e. those which commence the use of the IRB approach after the transitional period) to use the simpler approaches under the Basel II framework (which covers operational risk), instead of the 1988 Accord, as the basis for the capital floor calculation. In the light of such difference, AIs which commence the use of the IRB approach after the transitional period will be subject to a capital floor including operational risk but lower adjustment factors for the first three years of the IRB application.
Part 7 – Calculation of credit risk for securitization exposures		
49.	**Section 7.1 – Interpretation** "bankruptcy-remote" – In the context of a securitization	 In order to clearly reflect the "bankruptcy-remote" characteristic

	transaction, a special purpose entity (SPE) is used for the sole purpose that it will hold the assets sold by the originator of the transaction so that the interests of investors will not be jeopardized by the insolvency of the originator. It seems therefore a SPE is by definition "bankruptcy-remote". To add "bankruptcy-remote" as qualifier of a SPE may suggest that a SPE is not what is generally understood as a SPE but may be any kind of entity. That could lead to confusion and may not be conducive to the legislative intent.	of a SPE, paragraph (b) of the definition of "SPE" will be modified as follows: "*which insulates the underlying exposures transferred to it from the effects of default, insolvency or bankruptcy of the originator in the transaction.*" With this change, the definition of "bankruptcy-remote" and the reference to "bankruptcy-remote" in the definitions of "asset-backed commercial paper programme" and "traditional securitization transaction" can be deleted.
Part 8 – Calculation of operational risk		
50.	**<u>Sections 8.5, 8.6, 8.9 & 8.10 – calculation of capital charge for operational risk under BIA approach & STO approach</u>** The capital charge for each of the standardized business lines are calculated by multiplying the gross income derived from the standardized business line by a designated capital charge factor. AIs are then required to convert the capital charge for the business lines into risk weighted amounts by multiplying the capital charge of the business line by 12.5. Given that the "12.5" factor is the reciprocal of CAR of 8%, the factor should be adjusted to the reciprocal of the minimum CAR required of individual AIs by the MA (e.g. 6.25 in the case that an AI's minimum CAR requirement is 16%).	No, the formula should not be revised. Under Basel II, the risk-weighted amount for operational risk is calculated by multiplying the capital charge (calculated under various methods) by the '12.5' factor assuming a minimum CAR requirement of 8%. This means, for an example, If an AI has a minimum 8% CAR requirement and a risk-weighted asset of \$12.5m, then the capital requirement is \$1m (1m/12.5m = 8%). To satisfy a 16% requirement and assuming the risk-weighted asset remained the same at \$12.5m, the capital required will increase to \$2m. That is, 2m/12.5m = 16%. Thus, if a factor lower than 12.5 is to be used due to a higher minimum CAR of a particular AI, then the capital charge factor for the standardized business line, will need to be adjusted.

Part 9 – Calculation of market risk		
51.	**<u>Section 9.2 – Interpretation</u>** In the definition of - “commodity-related derivative contract”, “debt-related derivative contract”, “equity-related derivative contract”, and “exchange rate-related derivative contract”, the terms “futures contract”, “forward contract”, “swap contract” and “option contract” are not defined. It is not clear whether the linked notes and linked deposit are included as derivative contract.	Definitions for the terms “futures contract”, “forward contract”, “swap contract” and “option contract” will be added. Regarding the linked notes and linked deposits, we will amend the definition for “derivative contract” to address this issue (see item 9).
52.	**<u>Section 9.31(2)(a) – Other offsetting</u>** This subsection states that *"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%"* but it is not clear how to calculate the offset of up to 80%. The wording is slightly different to the Basel II requirement, which states that an 80% specific risk offset will be applied to the side of the transaction with the higher capital charge. Is the intention for the rule to be the same as the Basel II requirement or is there a reason for the difference in wording, if so guidance needs to be provided on how to calculate the offset?	In fact, the Basel II requirement relating to the 80% offsetting (paragraph 714 of the Basel II paper) is specified in section 9.30. Section 9.31 is to incorporate the Basel II requirements relating to partial allowance (paragraph 715 of the Basel II paper). Since the conditions for a position to be qualified for partial allowance under section 9.31 appear to be less stringent than those under section 9.30, the maximum offsetting to be allowed under section 9.31 should logically not be higher than 80% as specified under section 9.30. The Basel II framework does not prescribe any method to calculate the extent of offsetting for positions hedged by credit derivative contracts. It is up to individual AIs to develop their

		own systems or methods to effectively quantify such offsetting for capital calculation and risk management purposes.

Banking (Disclosure) Rules

	Comments Received (Summarized)	HKMA's Response
General		
1.	A number of other jurisdictions are also developing disclosure requirements in line with Pillar 3 of Basel II. No doubt, over the next few years there will be a process of "bedding down" and it is hoped that regulators may develop an international consensus on the key disclosure requirements. In addition, as HKFRS develop over time, there will be a need to revisit the Banking (Disclosure) Rules to ensure that it is kept current and in line with best practice internationally.	It is the HKMA's intention to ensure that disclosure requirements in Hong Kong remain in line with best practices in other leading financial centres. For this purpose the HKMA intends to keep under regular review the Banking (Disclosure) Rules, and to take account of both other regulators' approaches to the implementation of Pillar 3 and international accounting developments.
2.	Please provide an update on the status of the Guideline on Operation of the Banking (Disclosure) Rules which was annexed to the April 2006 version of the Disclosure Rules Consultation Paper but not enclosed with the Draft Rules released in September 2006.	The HKMA intends to assist AIs by issuing guidelines on various of the requirements in the Banking (Disclosure) Rules. It is intended that these guidelines will incorporate the guidance contained in the Guideline on Operation of the Disclosure Rules. The guidelines will be issued after the Banking (Disclosure) Rules are finalized.
3.	We note that disclosure of the "estimate of the fair value of collateral" is required by AIs incorporated in Hong Kong under sections 27(3)(a) and 48(3)(a) whereas disclosure of the "value of collateral" is required under sections 21(1)(c), 21(2)(c),	The HKMA expects an AI to disclose the value of collateral in line with the guidance provided in section C.5 of the "Guideline on Operation of the Disclosure Rules" which was Annexed to the April 2006 version of Disclosure Rules Consultation Paper. This

	37(2)(c). Similarly, disclosure of the "estimate of the fair value of collateral" is required by AIs incorporated outside Hong Kong under section 100(3)(a) whereas disclosure of the "value of collateral" is required under sections 95(2)(c) and 95(3)(c). Please provide detailed guidance on the disclosure of "value of collateral", a term which is not defined in the Banking (Capital) Rules or the Banking (Disclosures) Rules.	intention will be reflected in the guidelines (see response above).
4.	Some acronyms are not defined (e.g. ECAI and STC(S) in section 69). Cross referencing some definitions to the Capital rules also causes confusion. It may be more convenient to have one set of definitions to which the Banking (Capital) Rules and the Banking (Disclosure) Rules can refer.	The definitions in section 1.2 of the Banking (Capital) Rules (which include the definitions of ECAI and STC(S)) apply equally to the Banking (Disclosure) Rules by virtue of section 2(2). Parts 5, 6 and 7 of the Banking (Disclosure) Rules have also specifically applied the definitions in the relevant interpretation sections relating to the calculation approaches for credit risk, market risk and operational risk in the Banking (Capital) Rules. The present approach of incorporating definitions made in the Banking (Capital) Rules by reference is a common one used in statutory drafting and it is appropriate for these purposes, given that the definitions which have been incorporated are intended to have the same meaning as they do in the Banking (Capital) Rules. However, to facilitate AIs' practical application of the Banking (Disclosure) Rules, the HKMA will consider including in the guidelines a complete glossary of all the defined terms used in the Banking (Disclosure) Rules.
5.	The expression "designated at fair value through profit and loss" is used in various sections of the Rules (e.g. sections 24(2)(b)(iii), 37(4)(b) & (5), 38(1) & (4)(b)(ii), and 45(3)(b)(iii)) but is not defined. It is not entirely clear what it is intended to mean.	A financial instrument which is "designated at fair value through profit and loss" means that the instrument is valued at its market price with any gains or losses being passed directly to the institution's profit and loss account rather than, for example, being allocated to a reserve account. It is a concept which is commonly used in the financial industry in the preparation of financial

		statements (and is explained in the Hong Kong Financial Reporting Standards). As such, its meaning is understood by AIs and other prospective users of the Banking (Disclosure) Rules. "Fair value" has been defined in Section 1.2 of the Banking (Capital) Rules and that definition is incorporated into the Banking (Disclosure) Rules by virtue of Section 2(2) of those Rules. For these reasons, the HKMA does not consider it necessary to reduce "designated at fair value through profit and loss" to a definition.
6.	Throughout the Banking (Disclosure) Rules, the term "specific provisions" is mentioned despite that following the adoption of HKAS 39, this term is no longer used by banks.	The term "specific provisions" has been used to maintain consistency with the Banking (Capital) Rules. The term is defined in the Banking (Capital) Rules which closely follows the definition of individual impairment allowances contained in the accounting standards, and this definition is applicable to the Banking (Disclosure) Rules by virtue of section 2(2) of the Rules.
7.	Separate disclosure of information on impaired loans is required by the Banking (Disclosure) Rules. However the term "impaired loans" has not been defined. It should be noted that the definition of impaired loans (see HKAS39, para 58-70) in the accounting standards is different to the definitions for classified and non-performing loans used for prudential reporting purposes.	The term "impaired loans" is not intended to be limited only to the definition used in HKAS 39. As such, the term is sufficiently flexible to encompass non-performing loans used for prudential reporting purposes. The HKMA will clarify in the guidelines it intends to issue the accounting practices and principles an AI may follow for the purpose of the disclosure requirements in respect of impaired loans. (see also response 65 below)
Part 1 Section 2 – Interpretation		
8.	"associate" – this definition is wider than the accounting standard, as the former includes a natural person.	The definition will be revised to exclude natural persons.
9.	"effective interest method" – please take into account the fact	The definition will be revised to take into account the comments

	that financial assets and financial liabilities can have both interest income and interest expense.	raised.
10.	"effective interest rate" – please take into account the fact that both the amounts received and paid for financial assets or financial liabilities have to be considered in calculating effective interest rate.	The definition will be revised to take into account the comments raised.
11.	"financial assets or financial liabilities measured at fair value through profit or loss" - we note that the definition of financial assets or financial liabilities measured at fair value through profit or loss does not include derivatives and is thus inconsistent with HKAS 39, financial instruments: recognition and measurement. We are not sure if this is intentional.	The definition of this term in the Rules does not exclude "derivatives" which fall within the definition by virtue of sub-paragraph (a). We will clarify this point in guidelines.
12.	"foreign currency" – this definition is in conflicts with the definition in HKAS 21 where foreign currency is a currency other than the entity's functional currency.	The difference between the definition of foreign currency as defined in the Rules and the definition used in HKAS 21 has been noted. The definition "foreign currency" in the Rules is used in sections 3(7) and 3(9) (the application section). It is also used in sections 29, 50 and 102 which detail the disclosures an AI is required to make in relation to its foreign currency risks. In the context of each of these sections, "foreign currency" is intended to mean any currency other than the Hong Kong dollar.
13.	"investment property" - the definition of investment property in the Banking (Disclosure) Rules appears to require that only freehold interests or land held under a finance lease can be classified as investment property. This would effectively mean	In developing the definition of "investment property", the HKMA intends to follow the definition in the relevant accounting standards. As such, the definition is closely modeled on HKAS 40. The HKMA will clarify its interpretation in the guidelines.

	that no property in Hong Kong (where all privately owned land is held under operating leases) could qualify as investment property. We recommend that consideration be given to including land held under operating leases as set out in Paragraph 6 of HKAS 40 Investment Property.	
14.	“loans and receivables” – loans and receivables are defined as “non-derivative financial assets with fixed or determinable payments that are not quoted in an “active” market. In the Banking (Disclosure) Rules, the term active market is reflected as a “liquid” market. However, no explanation is given on the definition of liquid market and whether that is intended to follow the definition contained in the accounting standard (HKAS39, AG71).	It is the HKMA’s policy intent to follow the definition contained in the accounting standard. To improve clarity and avoid confusion with the term “liquid market” in the Banking (Capital) Rules where it is not defined, the HKMA will revise the definition of “loans and receivables” by substituting the words “liquid market” with “active market”, with a separate definition of “active market” along the following lines: ""active market", in relation to financial assets, means that the quoted price of the assets – (a) is readily obtainable and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency; and (b) reflects actual and regularly occurring transactions involving the assets, which take place on an arm’s length basis."
15.	“repossessed asset” – this definition refers to “an asset in respect of which the institution has acquired access or control (whether through court proceedings or otherwise)....”. No definition has been provided for “access”. We presume that “control” should be interpreted as in HKFRSs.	The words “access or” will be removed from the definition as the main concern is whether an AI has acquired control of the asset in question.
16.	“Swap deposit arrangement” – this refers to an arrangement	In order to broaden the definition of swap deposit arrangements as

	involving foreign currencies, while "foreign currency" is defined on page 6 as "any currency other than HKD". Such a narrow definition excludes HKD swap deposit. Suggest amending the definition of "swap deposit arrangement".	suggested (beyond those arrangements where the currency deposited is a foreign currency), the HKMA will replace the word "foreign" with the word "specified" with respect to the definition of "swap deposit arrangements".
Part 1 Section 3 – Application		
17.	**<u>Section 3(9) – "provisions"</u>** Exemption is granted to an AI with "in aggregate total assets less provisions of less than $10 billion (or the equivalent amount in foreign currency)". Does the term "provision" refer to provision against an asset or provision for liability? Suggest clarifying the term.	The term "provision" as it appears in section 3(9) refers to the provision for on and off balance sheet exposures as reported in the regulatory return relating to assets and liabilities submitted to the HKMA This has been set out in the definition for "relevant figures" in section 3(17). As stated in section 3(10), for the purposes of determining whether the exemption in section 3(9) applies, the MA shall make reference to the relevant average of the "relevant figures" over the relevant period of the institution. In any event, the HKMA will further emphasise what the term "provision" in the context of section 3(9) is intended to mean in the guidelines it intends to issue.
18.	**<u>Section 3(11)(b)</u>** When an AI's assets or deposits rise above the exemption threshold in 1 year but drops below in the next year, in order to be exempted again, the AI is required to demonstrate to the HKMA that "it is unlikely that it will cease to meet the criteria......in the foreseeable future". How long is the foreseeable future? What are the possible ways to demonstrate this? Suggest clarifying in the draft Rules or providing	In order to clarify how an AI can demonstrate to the satisfaction of the HKMA that it is unlikely that it will cease to meet the criteria referred to in subsection (7)(b), the HKMA will revise section 3(11)(b) along the following lines:- "(b) the institution submits to the MA a business plan, within such period (being a period reasonable in all the circumstances of the case), which (i) demonstrates to the satisfaction of the MA that, if it were

	operational guidance of the possible ways to demonstrate this.	implemented by the institution, it would be unlikely that the institution would cease to meet the criteria referred to in subsection (7)(b) during the period referred to in (ii); and (ii) covers an appropriate number of years in the future sufficient to demonstrate to the satisfaction of the MA that there are reasonable grounds for considering it unlikely that the institution would cease to meet the criteria referred to in subsection (7)(b) in the foreseeable future." What constitutes "an appropriate number of years in the future" will depend on the particular circumstances pertinent to each AI; hence the use of a generic phrase. However, the HKMA will include in its guidelines, guidance on the interpretation this phrase. The qualification "appropriate" as used in the phrase means that any guidelines the HKMA provides can be used to assist in ascertaining the nature of that qualification as it appears in the context of section 3(11)b – (see section 2(5) of the Banking (Capital) Rules which has been incorporated into the Banking (Disclosure) Rules by virtue of section 2(2) of those Rules.)
Part 2 Section 5 – Disclosure Policy		
19.	**<u>Section 5</u>** AIs may need more time than the 3 months currently envisaged to put in place a clearly documented disclosure policy and to obtain approval by the board of directors.	We accept the comment and will revise section 5 of the Rules to require an AI to have the disclosure policy in place not later than **<u>6 months</u>** after the commencement of this section or after the date on which it became an AI, whichever is later.
Part 2 Section 6 – Medium and location of disclosure and issue of press release		

20.	**<u>Section 6(4) – "containing, consisting"</u>** The draft Rules require the issue of a press release "containing the [disclosure] statement or consisting of the statement". These terms "consisting" and "containing" are not defined to enable an AI to understand and fulfil this requirement. We suggest that additional guidance is required.	"Containing" is to denote a situation where the Press Release covers both the disclosure statement along with information that goes beyond the strict confines of the disclosure statement. In this instance the press release can be said to "contain" the disclosure statement. If, however, the disclosure statement includes only those matters required to be disclosed under the Rules, then the Press Release "consists" of the statement. This point can be repeated in the guidelines.
21.	**<u>Section 6(4) and 88(3)</u>** To clarify that the issue of press release by an AI has to take place in Hong Kong.	Section 6(4) and 88(3) will be amended to reflect that an AI has to issue the press release to the press in Hong Kong.
22.	**<u>Section 6(11) and 88(10) – "prescribed summary"</u>** The definition of "prescribed summary" is unclear. It seems to require disclosure of both: - a summary of the data and information required under the draft Rules; and - how the complete information can be accessed. Please clarify what constitutes "a summary of all".	The definition of "prescribed summary" will be amended to reflect more clearly the policy intention. The intention is that the prescribed summary need only specify where the public can access the complete disclosures the AI is required to make under the Rules. The prescribed summary mechanism can be utilized in circumstances where the complete disclosures can be accessed by the public by one of the means specifically prescribed in the Rules (HK internet website, report and accounts etc).
23.	**<u>Section 6(11)</u>** We consider that it may be helpful for the Monetary Authority to provide guidance (perhaps in a separate Guidance Note) on the extent of aggregation of information that will be acceptable in presenting a prescribed summary of the Disclosure Statement.	Please see HKMA's response to comments 22 above.

Part 2 Section 8 – Verification		
24.	**<u>Section 8 – "independent"</u>** The draft Rules require the disclosed information to be "scrutinized and subjected to an independent internal review". Is the person "independent" of the preparing department, of Hong Kong management or of the AI as a whole? Suggest clarification.	The section will be amended to make it clear that the "independent internal review" has to be conducted by an AI's adequately qualified personnel who are independent of the AI's staff or management responsible for preparing the information which the AI is required to disclose pursuant to the Rules.
Part 2 Section 11 – Consolidated group level disclosures		
25.	**<u>Section 11(1) and (4)</u>** This section is unclear. It appears to require that all the information required by the draft Rules should be disclosed on a consolidated basis except information relating to capital structure and adequacy (i.e. section 24 and 45) which need to be disclosed in accordance with the basis agreed with the HKMA. Section 11(4) says that section 11(1) (i.e. consolidation requirement) does not apply to certain disclosures, e.g. income statement and equity information, and balance sheet information. However, AIs with subsidiaries should disclose on a consolidated basis for financial reporting purpose. Therefore, it seems that the current disclosure requirement in this respect is not consistent with financial reporting requirements.	Section 11(1) requires disclosure to be made on a "consolidated basis" as defined in the Banking (Capital) Rules. Therefore the disclosure to which section 11(1) applies concerns information relevant to an AI's CAR. The exceptions listed under section 11(4) relate to those disclosures to which the "consolidation basis" as defined in the Banking (Capital) Rules is not strictly applicable. As such, all section 11(4) provides is that the information in the sections listed need not be disclosed on "consolidation basis" as defined in the Banking (Capital) Rules. Certain of these sections, make clear from their context, the basis on which the information required has to be disclosed (for example section 28 relating to non-bank mainland exposures, section 29 relating to currency risk and section 30 relating to liquidity, all require disclosures to be made in the same manner as those disclosures were made in the returns submitted to the MA under section 63 of the BO). For the other sections

		referred to section 11(4), however, the basis on which such information can be disclosed is left to the AI's discretion to choose the most appropriate basis for the purposes of providing clarity in understanding for users of disclosures. Therefore the AI can make the disclosure on the consolidation basis it used for financial reporting purposes if it so chooses.
Part 3 – Interim financial disclosures to be made by AIs incorporated in Hong Kong		
26.	**<u>Section 19(1)</u>** The draft Rules could require disclosure of the following profit and loss items for completeness: (i) Impairment loss on property, plant and equipment (ii) Impairment loss of intangible assets	As the Rules only specify minimum disclosure requirements, it is not the HKMA's intention completely to duplicate all the disclosures required under financial reporting standards. This does not prevent an AI from making disclosure in addition to those required by the Rules.
27.	**<u>Section 20 and 36</u>** The balance sheet captions requiring analysis by maturity profile is not consistent with those captions included in the balance sheet presentation, e.g. "certificate of deposit held" is required to be separately disclosed in the maturity profile but these amounts are included in various line items on the balance sheet.	As explained above, the Rules only specify minimum disclosure requirements. AIs are free to provide any additional information or more detailed breakdowns of information if to do so might enhance the understanding of the users of the Disclosure Statement.
28.	**<u>Section 20(a)(ii) and 36(1)(a)(ii)</u>** The item "Placements with banks and other financial institutions" per FD-1 is now replaced with "Placements with banks". We would suggest clearer guidance be given on classifying balances with financial institutions which do not fall	The term "banks and other financial institutions" in FD-1 is defined as "AIs authorized under the BO and institutions regarded as banks by the appropriate supervisory authorities in their place of incorporation, and include central banks". This definition is equivalent to the definition of "bank" as defined in the Banking (Capital) Rules, except that "bank" does not include central banks

	within the definition of banks.	which are placed in the category of "sovereign" in the Banking (Capital) Rules. For any placements with central banks and non-bank financial institutions, AIs are expected to make separate disclosure as they consider appropriate. The HKMA will clarify its expectations in the guidelines.
29.	**<u>Section 20(a)(v), 36(1)(a)(v) and 94(a)(vii)</u>** The heading "loans & receivables" is too wide as it also includes placements with banks which is shown elsewhere in the balance sheet. Suggest heading for 20(a)(v): "Advances and other accounts".	We will make clear in the Rules that the disclosures made under "loans and receivables" exclude "cash and balances with banks" and "placement with banks" which are already disclosed pursuant to other sub-paragraphs within the same section. Note also that section headings do not operate in any way to vary, extend or limit the interpretation of the Rules (see section 18(3) of the Interpretation and General Clauses Ordinance CAP 1)
30.	**<u>Section 20(a)(v), 36(1)(a)(v) and 94(a)(vii)</u>** Accrued interest is still required to be separately disclosed. Traditionally, this amount typically referred to the amount of interest receivable from the borrowers as at the reporting date. However, under HKAS39 and HKAS18, interest income is recognized using effective interest method which means that the interest element now effectively forms part of the loan outstanding. Further, the calculation of effective interest could also include items such fees, commissions, etc so effective interest no longer necessarily reconciles directly with the amount of interest receivable from borrowers. Although this interest element can be analysed and disclosed separately, it is not correct to call this element of the loan "accrued interest".	The HKMA accepts the comments raised and will revise the Rules to remove the requirement of separate disclosure of accrued interest.
31.	**<u>Section 20(a), 36 and 94</u>**	

	The draft Rules could require disclosure of the following balance sheet terms, for completeness: (i) Acceptances on trade bills and liabilities for acceptances (ii) Deferred tax assets (iii) Intangible assets (iv) Goodwill	Please see HKMA's responses to comments 26 and 27 above.
32.	**<u>Section 20(b)</u>** Loan capital and customer deposits are financial liabilities and they can be designated as fair value through profit or loss (e.g. structured deposits) or amortised costs. As a result, the same disclosure requirements for CD issued and issued debt securities should also be applied to loan capital and customer deposits.	Please see HKMA's responses to comments 26 and 27 above.
33.	**<u>Section 20(b) and 36(1)(b) – "other revaluation reserves"</u>** Suggest replacing the term "other revaluation reserves" with "revaluation reserve".	Section 20(b) and 36(1)(b) will be revised to replace the words "other revaluation reserves" with "revaluation reserves".
34.	**<u>Section 20(b)(xi)</u>** Section 20 (balance sheet information) and similar sections require the disclosure of reserves, broken down into regulatory reserve, etc. Does it mean that AIs which only earmark a certain part of their reserves as regulatory reserve still have to disclose this earmarked regulatory reserve?	Yes. AIs are required to make appropriate disclosure of regulatory reserves regardless of which methodology (i.e. appropriation or earmarking) the AI uses to maintain such reserve.
35.	**<u>Section 22(1)(a) and 38(2)(a)</u>**	

	“Forward FX contracts arising from swap deposit arrangements” are excluded from the category of exchange rate contracts. Are such contracts not disclosed at all or are they intended to be included under “others”?	Such contracts are not required to be disclosed at all.
36.	**<u>Section 22(3)(a), 38(3) and 96(3)(a) – “total fair value”</u>** It is not clear whether “total fair value” refers to gross positive and negative amounts or the net amounts.	We will make clear in the Rules that the disclosure of total fair value of derivative transactions should be after the effect of valid bilateral netting agreements, and that the AI is required separately to disclose the amount of fair value that has taken into account the effect of valid bilateral netting agreements.
37.	**<u>Section 24(2)(b)(iv)</u>** “Regulatory reserve for general banking risks” has not been defined in the Rules.	The regulatory reserve (RR) refers to that part of an AI’s reserves that it is required to maintain in order to satisfy Schedule 7, section 9 of the BO. This makes it an on-going authorization requirement for an AI to maintain adequate provisions “for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.” Since the introduction of new accounting standards in 2005, accountants only require provisions to be made against losses that have already occurred. By contrast both the BO and prudent banking practice requires provisions against losses that might reasonably occur in the future. The RR provides a mechanism to make these provisions against potential future losses and since this is specific to the banking industry, the meaning is commonly understood by AIs. Further, the HKMA has issued various guidance / circulars to AIs setting out the nature and purpose of regulatory reserve as explained above. As such, the term is already commonly used and generally

		understood in the Hong Kong banking industry. Accordingly, the HKMA do not propose to define it in the Rules.
38.	**<u>Section 24(2)(b)(ii) and 45(3)(b)(ii)</u>** The Capital Rules (section 3.10(3) on p.153) requires deduction from supplementary capital of any overall deficit arising from the revaluation of securities not held for trading purposes and securities designated as FVTPL. Suggest specifying the "fair value gains" in draft Rules as "fair value gains less losses" other than those already recognised through the income statement.	Given that any overall deficit for equities and debt securities designated at fair value through profit or loss falling within section 3.8(1)(b)(ii) of the Banking (Capital) Rules should have been reflected in the profit or loss account (and hence reflected in the calculation of core capital as a deduction by reason of section 3.4(e)), section 3.10(3) of the Banking (Capital) Rules will be revised to reflect that the overall deficit which is required to be deducted from supplementary capital is only applicable to available-for-sale equities and debt securities falling within section 3.8(1)(b)(i) . Consequential to the proposed amendments made in the Banking (Capital) Rules, sections 24(2)(b)(ii) and 45(3)(b)(ii) of the Banking (Disclosure) Rules will be amended to require the disclosure of the AI's reserves which are attributable to fair value gains on revaluation of its holdings of available-for-sale equities and debt securities (after netting of any overall deficit required to be deducted from supplementary capital as referred to in section 3.10(3) of the Banking (Capital) Rules).
39.	**<u>Section 24(8) and 45(9)</u>** In the definition of "relevant capital shortfall", reference is made to "minimum capital requirements" of a subsidiary. The expression has not been defined. It is not clear what it exactly means.	"Relevant capital shortfall" refers to that amount which an AI is required to deduct from its core and supplementary capital under section 3.14(2)(h) of the Banking (Capital) Rules. Section 3.14(3) of the Banking (Capital) Rules describes how the relevant capital shortfall is determined and section 3.14(6) specifies that relevant capital shortfall in relation to a subsidiary of an AI means the amount specified in a notice under section 3.14(3) given to the

		institution in respect of that subsidiary. To improve clarity, the HKMA will revise the definition of "relevant capital shortfall" to provide clear guidance and reference to section 3.14(2)(h) of the Banking (Capital) Rules.
40.	**<u>Sections 25(5) and 46(12)</u>** The definition of "cross-border claims" has not specified what a cross-border claim is. It is not clear whether claims on entities in neighbouring regions of China, e.g. Macau, Mainland China and Taiwan, are cross-border claims, since in such cases no national border has been crossed.	For the purpose of disclosure in this section, claims on entities in neighbouring regions of Mainland China, Macau and Taiwan will be treated as cross-border claims. This is in line with existing disclosure practices. This is achieved in the Banking (Capital) Rules by the following means: Sections 25(5) and 46(12) refer to a breakdown of cross-border claims by major countries. "Country" is defined in section 2(1) of the Banking (Capital) Rules to include- (a) subject to paragraph (b), any part of a country; and (b) any jurisdiction except a restricted jurisdiction. By virtue of section 2(2) of the Banking (Disclosure) Rules, the definition of "country" in the Banking (Capital) Rules is imported into the Banking (Disclosure) Rules. However, the HKMA will revise the definition of "cross-border claim" in the Banking (Disclosure) Rules to avoid any lack of clarity on this point.
41.	**<u>Section 26(2) – "the extent"</u>** It is not clear whether "the extent to which loans and advances.....are covered by collateral or other security" refers to	Section 26(2) is intended to continue the current disclosure practices of AIs under the Financial Disclosure Guidelines. Our intention is

	the percentage of the value of collateral to loans and advances, or the description of loans to which industry sector are secured. If the former interpretation is correct, (1) please clarify what is meant by the value of collateral and how to determine that value, is it expected to be the current market value, the discount present value using the original effective interest rate or the lower of loan amount and collateral value for each loan, similar to the illustrative examples in Annex G of FD-1? (2) whether the percentage applies to each industry sector?	for an AI to disclose either the percentage of the value of collateral to loans and advances or in absolute amounts to indicate the extent that the loans and advances are covered by collateral or other security. The HKMA will provide further guidance on the disclosures required by this section in the guidelines.
42.	**Section 26(3)(c)** Currently, the breakdown of "the amount of new provisions charged to profit or loss" by counterparty type or industry sector is not required. In order to fulfil this, an AI will need to analyse each counterparty type or industry type's write-off, recoveries and unwind discount, which will be very time consuming.	In view of the fact that the requirement in section 26(3)(c) may be too burdensome in practice for AIs, it will be removed. Nevertheless, the same requirement in section 47(3)(c) will remain applicable for AIs in relation to annual reporting periods.
Part 4 – Annual financial disclosures to be made by AIs incorporated in Hong Kong		
43.	**Section 32 – Interpretation** "hedges of net investment in a foreign operation" – HKAS 21 contains two notions of currency (a) functional currency – currency in which the AI notionally keeps its books and records (b) presentation currency – currency used in the financial statements. The definition should use the "functional currency" notion (formal definition is in HKAS 21). Wording of "prepared" could be taken to mean "presentation currency". Suggested wording for (a)(ii) – "the activities of which are based	The HKMA will revise sub-paragraph (a)(ii) of the definition along the following lines: "The products, services and costs of which are principally denominated in a currency other than that in which the products, services and costs of the institution are principally denominated; and"

	or conducted in a currency other than that of the primary economic environment in which the institution operates”.	
44.	**<u>Section 32 – Interpretation</u>** “related party” – The definition of “Related Party” in Part 4, Section 32 and Section 43 (related party transactions) is not as clear as the definition in HKAS 24 (Related Party Disclosure). HKAS 24 only includes immediate members of the family, meaning that influence must exist between these members and the reporting entity before these members become reportable. The draft disclosure rule includes : 1. a member of the Key Management Personnel of the institution; and 2. one who is a relative in accordance with Section 79(1) of the Banking Ordinance. It is difficult to define “Key Management Personnel” in AIs, as different institutions have different structures and personnel hierarchies. In addition, the definition of “Relative” in Section 79 of the Banking Ordinance covers a broad range of persons, including cousins and ex-spouses of directors, which are not included as a “Related Party” in HKAS 24. It is suggested that the definitions of “Relative” and “Related Party” should be refined in the draft disclosure rule in an effort to bring these terms in line with the requirement of HKAS 24.	The HKMA’s intention is for the definition of "related party" to have the same scope as the definition of "related party" in HKAS 24. The HKMA will issue guidelines to clarify its expectations in this regard. Accordingly, the guidelines will clarify that the HKMA expects AIs to interpret the phrase "key management personnel" in accordance with the definition of the same term in HKAS 24. The HKMA proposes amending paragraph (e) of the definition of "related party" in the Banking (Disclosure) Rules to read: *"(e) who is a relative, within the meaning of section 79(1) of the Ordinance, of any individual falling within (a) or (d) and, in his dealings with the institution, may be expected to influence or be influenced by that individual"* This amendment incorporates the substance of the definition of "close member of the family of an individual" in HKAS 24. Since the scope of the definition of "related party" will match that in HKAS 24, the disclosures that an AI is required to make in relation to related party transactions will mirror the disclosure it makes in its financial statements. In other words, an AI will be able to discharge its obligations under section 43 of the Rules by making the same disclosures it is already required to make in its financial statements.

45.	**<u>Section 34(2)(a)</u>** This section requires disclosure of accounting policies, practices and methods an AI uses for credit risk exposures. It appears that the scope of requirement is too extensive if "practices and methods" are required for disclosure purpose.	The scope of disclosures required under section 34(2)(a) reflects an existing disclosure practice which has not previously raised any concerns. As it is important for the users of disclosures to understand how an AI manages its risk exposures (e.g. the measurement basis for loans), the HKMA does not regard the requirement under this section as being too extensive.
46.	**<u>Section 35(3)(a)</u>** AIs set aside provisions for depreciation and impairment loss of assets according to HKAS 16, 32, 38, 39 and 40. If the intention is to require disclosure of all provisions recognised in accordance with standards such as HKAS 19 and HKAS 37, then the requirement needs to be reworded. For example, the DRs could specify "set aside for provisions that are classified as liabilities...."	The HKMA considers that the current drafting of section 35(3)(a) reflects the existing disclosure practice (as it is intended to) and therefore does not need to be changed. However, for the sake of clarity, further guidance on the disclosures required under this section will be provided in the guidelines.
47.	**<u>Section 36(1)(a)(viii)</u>** It appears that no date for the valuation of assets has been specified. Section 37(9) seems to assume that valuation of different assets may be made at different points of time, which could be years apart. That may not reflect the true value of the assets at the reporting date and consequently may distort the true picture of the financial well-being of an AI.	Section 2(3) of the Banking (Disclosure) Rules provides that unless the context otherwise requires, a disclosure should be made as at the reporting date. As such, the values to be disclosed are those current as at the reporting date. In terms of the frequency of valuation, the intention of the Rules is to follow the standard accounting practices on valuation relating both to frequency of valuations and scrutiny by external auditors. It is a requirement under accounting standards that revaluations are made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined

		using fair value at the balance sheet date. Valuations made with this frequency are sufficient to provide auditors with the assurance that financial statements represent a "true and fair view" of the financial condition of an enterprise.
48.	**<u>Section 37</u>** It is observed that "held-to-maturity securities" has not been defined in the Rules whilst "held-to-maturity investments" has been defined. Please consider whether the former expression should be defined to remove any uncertainty as to its meaning.	As "held-to-maturity investments" is defined as "financial assets of the institution (other than derivative contracts)", it follows that "held to maturity securities" are a sub-set of financial assets. As such, the HKMA does not propose to define "held-to-maturity securities" separately as they are already captured in the definition of "held-to-maturity investments."
49.	**<u>Section 37(6)</u>** For the purposes of reporting the maturity profile, the term "Undated" has been replaced by "within an indefinite period" in the Rules. The purpose of the change and whether AIs are expected to continue to apply the same definition (i.e., as for "Undated") to classify items to the "within an indefinite period" category is unclear.	The use of the term "within an indefinite period" in the Rules is intended to reflect the term "undated" used in the current requirements. The former term has been used to conform with legislative drafting style. As such, although a different form of words has been used, the essence of the meaning is the same. Hence, in practice, the HKMA expects no change in AIs' current disclosure practices in respect of this item. The HKMA will clarify its expectations on this point in the guidelines.
50.	**<u>Section 38(1)</u>** It is not clear how detailed the requisite disclosure should be. The requirement seems potentially to require disclosure of confidential commercial information, which, if revealed, may adversely affect the effectiveness of the AI's use of derivative transactions to achieve its objective.	The disclosures that are required to be made under this sub-section are the same as those that are already required under the relevant accounting standard. These disclosures are relatively high level and have not in practice given rise to confidentiality concerns. The HKMA will clarify its expectations in this regard in guidelines. In the event that an AI has confidentiality concerns relating to any requirement under the Rules it may also seek to avail itself of an exemption from the disclosure by virtue of section 9 of the Banking

		(Disclosure) Rules.
51.	**<u>Section 38(4)(b)</u>** AIs may have derivatives which are hedging economically amortised cost assets or liabilities. In addition, many AIs' derivative activities are driven by customer requests as opposed to speculative trading. The above types of derivatives do not clearly fall under any of the categories listed in section 38(4)(b). Suggest the following categories: (i) those which qualify as hedges for accounting purposes (ii) those which do not qualify as hedges for accounting purposes but which are managed in conjunction with the financial instruments designated at fair value through profit or loss (iii) those entered into for other purposes including trading.	The HKMA accepts the comment, and will revise section 38(1) and 38(4)(b) to reflect the changes.
52.	**<u>Section 41</u>** Suggest adding exemption for fair value disclosure under HKFRS 7 (i.e. copy paragraph 29 of HKFRS 7 in section 41).	The HKMA will revise section 41 to reflect the exemption and bring the section more in line with the accounting standards.
53.	**<u>Section 43</u>** The draft Rules require disclosure of "the institutions' policy for lending to related parties". We suggest that there should be clarification on the extent of the disclosure required in the operational guidance.	The HKMA will clarify its expectations concerning the disclosures required under this section in the guidelines.

54.	**<u>Section 45(6), (7)</u>** It is not clear whether "core capital ratio" is calculated on a consolidated basis or solo basis.	The basis of disclosure relating to information to be disclosed in section 45 is governed by sections 11(1), 11(2) and 11(3). Essentially, these provide that the basis of disclosure shall be on a consolidated basis (section 11(1)) unless an AI is only required to calculate its capital adequacy ratio on a solo basis pursuant to the Banking (Capital) Rules, in which case disclosure will be on a solo-basis (section 11(2)). An AI which makes its disclosures on a consolidated basis can in addition make disclosures on a solo or solo-consolidated basis if it reasonably believes that to do so would provide greater clarity to a user of the disclosure (section 11(3)).
55.	**<u>Section 45(8)</u>** Reference is made to "regulatory reserve" which has not been defined in the Rules. It is not clear what it comprises of.	Please see HKMA's response to comments 37 above.
56.	**<u>Section 46</u>** This section requires, for each major business activity, disclosure of "particulars" of the major business activity in relation to total operating income, etc. It seems that the word "particulars" is too vague and further guidance is beneficial to the banks for disclosure purpose.	The HKMA will clarify its expectations on the disclosures required under this section in the guidelines.
57.	**<u>Section 46(1)(c)</u>** The breakdown of major business activities involves operating assets and profit and loss items. Accordingly the breakdown is not only consistent with the figures in "audited income statement" but also the figures in the balance sheet. Suggest	The HKMA accepts the comment and will revise section 46(1)(c) to replace the words "audited income statement" by "audited financial statements".

	amending the term to be "audited financial statements".	
58.	**<u>Section 46(4), 46(5)(b)</u>** The 10% threshold for geographical analysis is based on assets, liabilities, income or profit "arises from, or is booked, in a single country or geographical segment". A loan, which was originated in China but booked in the HK branch, could be classified in 2 geographical segments. Suggest deleting the term "arises from" in 46(4) and deleting 46(5)(b).	To improve clarity, section 46(4) will be revised to remove the words "arises from, or" such that the respective breakdown required in this section will be consistently based on the amount booked in a single country or geographical segment. Consequential to the proposed amendments above, section 46(5) will become redundant and therefore will be removed from the Rules.
59.	**<u>Section 47(3)</u>** In relation to sector information in section 47(3) – the definition of an "industry sector" is unclear.	As stated in section 47(3), AIs should make disclosures by industry sector based on the AI's internal management classifications (rather than any specific definition of industry sector). The HKMA's expectations on this point will be clarified in the guidelines.
60.	**<u>Section 49 and 101</u>** It is not clear what the criteria are for determining whether or not an AI's Mainland exposures are material.	Section 1.2(5) of the Banking (Capital) Rules specifically provides that where any matter is qualified by the word "material" then, for the purpose of assisting in ascertaining the nature of the qualification, regard is to be had to any guidelines issued under the BO. This section applies equally to the Banking (Disclosure) Rules by virtue of section 2(2) of those Rules and the guidelines will assist in ascertaining the nature of the word "material" as it applies in sections 49 and 101 of the Rules.
Part 5 – Additional annual disclosures to be made by AIs using STC Approach to calculate its credit risk for non-securitization exposures		

61.	**<u>Section 59 and 81</u>** According to the consultation paper on Banking (Disclosure) Rules issued in April 2006, in paragraph 5.6.1, it is clearly stated that the disclosures of credit risk mitigation exclude those related to OTC derivative transactions, repo-style transactions and credit derivative contracts (other than recognized contracts) when making both qualitative and quantitative disclosures. However, from the Banking (Disclosure) Rules issued in September 2006, the above scope exclusion is only mentioned in the qualitative disclosure requirements under section 59(1). It is not clear whether the scope exclusion applies to quantitative disclosure requirements under section 59(2).	It is the HKMA's intention to apply the scope exclusion for both qualitative and quantitative disclosures within sections 59 and 81. Section 59(1) and (2), and section 81(1) and (2) will be revised to make clear this intention.
62.	**<u>Section 59(2)(a)</u>** This section requires the AI to disclose the total exposure which is covered by recognized collateral. Please clarify whether the total exposure shall mean the principal amounts for on-balance sheet exposures and credit equivalent amounts for off-balance sheet exposures.	The HKMA confirms that the total exposure means the principal amounts for on-balance sheet exposures and credit equivalent amounts for off-balance sheet exposures, net of any specific provisions. AIs should ensure the same reporting methodology is consistently adopted in complying with the Rules. The HKMA will clarify its expectations on the disclosures required by this section in the guidelines.
Part 6 – Additional annual disclosures to be made by AIs using BSC Approach to calculate its credit risk for non-securitization exposures		
63.	**<u>Section 69(1)(a)</u>** This requires "a description of its involvement in each of the securitization transactions". While the securitization market	We will amend section 69(1)(a) to permit the disclosures to be made according to classes of exposures rather than on individual

	may not be big at this time in HK, it may grow significantly. We wonder if it would be more useful to require disclosure of "each type", or allow for some summarised data.	transaction basis. This amendment will also apply to section 60(4)(a) for AIs using STC approach and section 82(4)(a) for AIs using IRB approach.
Part 7 – Additional annual disclosures to be made by AIs using IRB Approach to calculate its credit risk for non-securitization exposures		
64.	**<u>Section 79(3)</u>** In the definition of "long run", reference is made to "one economic cycle". An economic cycle is not capable of being precisely identified and depends very much on a person's interpretation of market data. Please consider whether it would be preferable to define "long run" in quantitative terms. The uncertain meaning of "long run" may affect the effectiveness of the provisions of section 79.	The concept does not lend itself to precise quantitative definition given that economic cycles differ from time to time and country to country. There is, however, sufficient consensus in the banking industry on a period covered by an economic cycle ensuring that in practice AIs should not be uncertain of the meaning of this provision. In view of these considerations the HKMA considers that the requirement as presently drafted is appropriate for disclosure purposes.
Part 8 – Disclosures to be made by AIs incorporated outside Hong Kong		
65.	**<u>Section 93(1)(e) and 94(a)(vii)(D)</u>** An overseas incorporated AI may not adopt HKFRS/IFRS, and it may not have equivalent provision charge for impaired loans and receivables and collective and specific provisions. Suggest clarifying what disclosure requirements apply in such cases.	The phrase "impaired loans and receivables" is not confined to the definitions used in the HKFRS and IFRS and therefore if an AI follows a different accounting standard for calculating its provisions for impaired loans and receivables then these provisions can be disclosed for the purposes of sections 93(1)(e) and 94(a)(vii)(D). In addition, the HKMA will include in its guidelines the mapping of pre- and post- accounting terms that the HKMA issued in April and July 2005. As such, AIs in the circumstances described will be able to refer to the HKMA's guidelines for clarification of the HKMA's expectations in this

		regard.
66.	The disclosure requirements for overseas incorporated AIs (branches) are similar in many respects to the existing HKMA Financial Disclosure Guidelines which pre-date the adoption of IFRS. Given that many jurisdictions around are moving to adopt IFRS, it is possible that many of these institutions could also be reporting under IFRS for their internal or head office reporting purposes. In such a case, an additional effort would be required for these institutions to prepare disclosures using old GAAP. We would suggest that these AIs be given a choice to make disclosures which are more in line with those that are required for local AIs.	See the reply to comment 65, above. The HKMA does not prescribe that the disclosures made by overseas incorporated AIs should be made in accordance with a particular accounting standard (e.g. IFRS). Provided that the AIs make disclosures pursuant to the requirements based on its applicable accounting standard, such disclosures will satisfy the requirements in the Rules.
67.	**<u>Section 100(1)(a), (1)(b), (2)(a) and (2)(b)</u>** The terms "gross amount" in section 100(1)(a) and "absolute amount" in section 100(1)(b) appear to have the same meaning.	It is the HKMA's intention for an AI to disclose the gross amount of overdue loans and advances to customers / banks in terms of both the absolute amount and the percentage of its total loans and advances. We will conform section 100(1)(a), (1)(b), (2)(a) and (2)(b) to section 48(1) and (2) which have specified the same disclosure requirements.

Ends.